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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, ~~1931~~ 32

No. ~~824~~ 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 24, 1932
CERTIORARI GRANTED APRIL 18, 1932

(36638)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1931

No. 824

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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A [Caption omitted.]

1 Before United States Board of Tax Appeals

Docket No. 38855

HENRY HARMEL, PETITIONER

versus

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearance:
For taxpayer, Robert Ash, Esq., Thos. J. Reilly, Esq.
For. commr., J. A. Adams, Esq.

Docket entries

1928
May 23—Petition received and filed. Taxpayer notified. (Fee paid.)
May 24—Copy of petition served on general counsel.
May 24—Notice of appearance of Robt. Ash & Thos. J. Reilly as counsel for taxpayer filed.
July 3—Answer filed by G. C.
July 14—Copy of answer served by taxpayer. General calendar.
1929
May 29—Motion to place on the Wichita Falls, Texas, circuit calendar, filed by taxpayer. 5/31, granted.
Oct. 17—Hearing set, Nov. 27, 1929, at Dallas, Texas.
Nov. 27—Hearing had before J. J. Marquette, div. 1, on the merits. Submitted. Briefs due 2/1/30.
Dec. 31—Transcript of hearing, 11/27/29, filed.
1930
Jan. 31—Brief filed by taxpayer.
Mar. 24—Findings of fact and opinion rendered; Mr. Marquette, div. 1. Judgment will be entered under rule 50.
Apr. 5—Notice of settlement filed by G. C.
Apr. 9—Hearing set, April 30/30, on settlement.
Apr. 21—Consent to settlement filed by taxpayer.
Apr. 25—Judgment entered; J. J. Marquette, div. 1.
Oct. 25—Petition for review to U. S. Circuit Court of Appeals, 5th Circuit, with assignments of error filed by taxpayer.
Oct. 25—Proof of service of petition filed.
Oct. 25—Designation of record filed.
Oct. 25—Proof of service filed.

Now, March 14, 1931, the foregoing docket entries certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals

[Title omitted.]

Petition

Filed May 23, 1928

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT: FAR: B-1—IMB-60D) dated April 4, 1928, and as a basis of his proceeding alleges as follows:

3 1. The petitioner is an individual whose address is Megargel, Texas.

2. The notice of deficiency, a copy of which is attached and made a part of this petition, dated April 4, 1928. The petitioner has no knowledge as to the date it was mailed.

3. The taxes in controvery are income taxes for the calendar years 1924 and 1926 in the amounts of $2,587.24 and $367.68, respectively, and an overassessment for the year 1925 in the amount of $727.78.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The commissioner erred in refusing to allow depletion on cash bonuses received for leasing proven oil land.

(b) If the commissioner is correct in refusing to allow depletion on bonuses as referred to in paragraph 4 (a), he erred in refusing to tax the sale of the leases as a sale of capital assets.

(c) The commissioner erred in adding to gross income "unidentified" bank deposits of $1,000 and $500, made December 5 and December 24, 1924, respectively.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) and (b). (1) For more than two years prior to 1924 petitioner was the owner in fee of the whole of block 2401 of the T. E. & L. survey, Archer County, Texas, which consisted of 320 acres. Prior to October 13, 1924, the block was proven for oil production.

4 (2) On October 13, 1924, the petitioner leased to Murchison, Fain and Golding the west 40 acres of the south half of block 2401 for $20,000 in cash and $20,000 to be paid out of 7/16ths of the gross production of the lease; $2,562.54 of the oil payment was received in 1924, and $17,437.46 was received in 1925.

(3) On October 21, 1924, the petitioner leased to J. A. Gardner the 80 acres in the south half of block 2401 adjoining the 40 acres leased to Murchison, Fain and Golding for $44,000 in cash and $44,000 to be paid in oil. None of the oil payment was received in 1924; $36,780.03 of the oil payment was received in 1925. The lease to Gardner required the drilling of certain wells on the lease, the first to be drilled within 30 days.

(4) Two other leases were sold off block 2401 by petitioner, for which he received bonuses of $3,000.

(5) In adjusting the tax liability of the petitioner the respondent refused to allow depletion on the $64,000 oil-lease bonuses received in cash. Instead, respondent took the $64,000 plus the $3,000 bonus received from the other leases mentioned in subparagrap' (4), deducted $10,000 commissions paid, and treated the $57,000 figure thus arrived at as proceeds from lease sales, whereas the whole of the $64,000 should have been treated as prepaid royalties.

(6) The respondent added to gross income a deposit of $1,000 made December 5, 1924, in the Megargle State Bank and a deposit of $500 made December 24, 1924, in the same bank. Both the deposits were transfers from the petitioner's account in the First National Bank of Wichita Falls to the petitioner's account in the Megargle State Bank, and neither in any way represented income.

5 Wherefore, petitioner prays that this board may hear the proceeding and

(a) Determine that the cash bonuses received from Murchison, Fain and Golding, and J. A. Gardner were prepaid royalties subject to depletion.

(b) In the event the board determines the cash bonuses referred to were not prepaid royalties, determine that the lease sales were sales of capital assets.

(c) Determine that the deposits of $1,000 made December 5, 1924, and $500 made December 24, 1924, in the Megargle State Bank should not be included in income.

(d) Grant such other and further relief as the board may deem proper.

ROBERT ASH,
THOMAS J. REILLY,
Munsey Building, Washington, D. C.,
Attorneys for Petitioner.

PARFET & MARTLEW,
Wichita Falls, Texas,
Of Counsel.

[*Duly sworn to by Henry Harmel; jurat omitted in printing.*]

6 *Exhibit to petition*

TREASURER DEPARTMENT,
Washington, Apr. 4, 1928.

MR. HENRY HARMEL,
Megargel, Texas.

SIR: In accordance with section 274 of the revenue act of 1926, you are advised that the determination of your tax liability for the year 1924, 1925, and 1926 discloses a deficiency of $2,954.92 for the years 1924 and 1926 and an overassessment of $727.78 for the year 1925, as shown in the attached statement.

The section of the law above mentioned allows you an appeal to the United States Board of Tax Appeals within sixty days from the date of the mailing of this letter. However, if you acquiesce in this determination, you are requested to execute the enclosed Form A and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7.

Respectfully, D. H. BLAIR,
Commissioner.

By (Sgd.) C. R. ALLEN,
Deputy Commissioner.

Enclosures: Statement; Form A; Form 882.

7 STATEMENT

IT:FAR:B-1—IMB-60D. APR. 4, 1928.

In re: Mr. Henry Harmel, Megargel, Texas

Years	Deficiency in tax	Overassessment
1924	$2,587.24	
1925		$727.78
1926	367.68	
Totals	2,954.92	727.78

The report of the internal revenue agent in charge, Dallas, Texas, covering an investigation of your income-tax returns for the years 1924 to 1926, inclusive, has been reviewed and approved by this office.

1924

Net income reported on return		$2,016.57
Add:		
1. Increase in business income	$2,177.52	
2. Depletion disallowed	2,259.18	
3. Increase in oil income	51.00	
4. Right-of-way sales	22.50	
5. Bonus income	57,000.00	
		61,510.20
Net income adjusted		63,526.77

COMPUTATION OF TAX

Net income adjusted	63,526.77
Less: Exemption	1,000.00
Income subject to normal tax	62,526.77
8 Normal tax, at 2%, on $4,000.00	80.00
Normal tax, at 4%, on $4,000.00	160.00
Normal tax, at 6%, on $54,526.77	3,271.61
Surtax on $63,526.77	6,235.88
Total tax	9,747.49
Brought forward	9,747.49
Less: Credit of 25% for earned net income	20.00
Total tax assessable	9,727.49
Tax previously assessed	7,140.25
Deficiency in tax	2,587.24

Explanation of changes

1. As shown in Schedule number 2 of the agent's report, the increase in business income is due to the following changes:

Gross sales increased	$777.02
Unidentified deposits not reported	1,500.00
Plowing expenses allowed	80.00
Abstract fees increased	19.50

2. The deduction for depletion has been decreased from $3,511.94 to $1,252.76. The amount of depletion was limited to 50% of the income of $2,505.52 received from oil royalty received in accordance with article 201 (h), revenue act of 1924.

3. The increase of $51.00 in oil income is due to an amount disclosed by oil-run tickets which was not reported.

4. The increase of $22.50 in the right-of-way sales represents an amount not included in the total of $165.50 reported by you.

9 5. The bonus income of $57,000.00 represents lease sales, the tax on which has been computed under section 208 (b) in your return, whereas it has been treated as bonus income taxable at ordinary rates. (See Income Tax Unit decision number 2077, Cumulative Bulletin III–2, page 47.)

1925

Net income reported on return			$105,147.16
Add:			
1. Royalty income		$24,014.60	
Deduct:			
2. Bonus income	$5,411.90		
3. Depletion increase	21,513.83		
		26,925.73	
			2,911.13
Net income adjusted			102,236.03

COMPUTATION OF TAX

Net income adjusted	$102,236.03
Less: Exemption	1,500.00
Income subject to normal tax	100,736.03
Normal tax, at 1½%, on $4,000.00	60.00
Normal tax, at 3%, on $4,000.00	120.00
Normal tax, at 5%, on $92,736.03	4,636.80
Surtax on $102,236.03	12,107.21
Total tax	16,924.01
Less: Credit of 25% for earned net income	13.13
Total tax assessable	16,910.88
Tax previously assessed	17,638.66
Overassessment	727.78

10 Explanation of changes

1. Reconciliation of royalty income difference:

Texhoma Oil Company, ⅛ interest	$10,947.49
Harmel, A ⅛ interest, Murcheson, Fain, and Golding	37,600.94
Harmel, C ⅛ interest, Murcheson, Fain, and Golding	51,904.07
Total royalty on oil received	100,452.50
Total royalty on oil reported	76,437.90
Increase in royalty income	24,014.60

2. Reconciliation of difference in lease sale bonuses:

Harmel, ⅛ interest, Texhoma Oil Company	$36,780.03
Harmel, 6⅛, Murcheson, Fain, and Golding	17,437.46
Total bonus oil received	54,217.49
Brought forward	54,217.49
Total bonus oil reported	59,629.39
Decrease in bonus oil	5,411.90

3. Depletion has been increased from $21,020.42 to $42,534.25 in accordance with section 204 (c) (2) of the revenue act of 1926.

The overassessment shown herein will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district, and will be applied by that official in accordance with section 284 of the revenue act of 1926.

11 1926

Net income shown on return		$32,210.76
Add:		
1. Increase in oil income	$3,620.98	
Deduct:		
2. Depletion at 27½%	995.77	
		2,625.21
Net income adjusted		34,835.97

COMPUTATION OF TAX

Net income adjusted	$34,835.97
Less: Exemption	1,500.00
Income subject to normal tax	33,335.97
Normal tax, at 1½%, on $4,000.00	60.00
Normal tax, at 3%, on $4,000.00	120.00
Normal tax, at 5%, on $25,335.97	1,266.80
Surtax on $34,835.97	1,295.24
Total tax assessable	2,742.04
Less: Credit of 25% for earned income	13.13
Net tax assessable	2,728.91
Brought forward	2,728.91
Tax previously assessed	2,361.23
Deficiency in tax	367.68

Explanation of changes

1. Reconciliation of difference in royalty on oil received:

Harmel, A and B ⅛ royalty, Humble O. and R. Company	$18,412.10
12 Harmel, C ⅛ royalty, Humble O. and R. Company	31,869.84
Royalty income, Humble O. and R. Company	768.45
Mutual Oil Company, ⅛ royalty	3,482.71
Bonus oil received, Humble O. and R. Company	7,219.97
Phillips Petroleum Company (gas)	367.16
Total income, oil and gas, received	62,120.23
Total oil and gas income reported	58,499.25
Increase in oil and gas income	3,620.98

2. Depeltion has been increased from $16,087.29 to $17,083.06, in accordance with section 204 (c) (2) of the revenue act of 1926.

The right of petition, as indicated on page one of this letter, refers only to any deficiency in tax indicated herein, inasmuch as there is no provision in the revenue act of 1926 granting the right of petition against the determination of any overassessment found upon a review of your returns.

Payment of the tax should not be made until a bill is received from the collector of internal revenue for your district, and remittance should then be made to him.

Now, March 14, 1931, the foregoing petition certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

13 Before U. S. Board of Tax Appeals

Answer

Filed July 3, 1928

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

(1) Admits the allegations contained in paragraph 1.

(2) Admits the allegations of fact contained in paragraph 2, and avers that said deficiency letter was mailed to the petitioner on April 4, 1928.

(3) Admits that the taxes in controversy are income taxes for the calendar years 1924 and 1926 in the amounts of $2,587.24 and $367.68, respectively, but denies that the board has jurisdiction of the year 1925 for the reason that the respondent did not propose a deficiency for that year.

(4) Denies that the respondent erred in the determination of said deficiency as alleged in subparagraphs (a) to (c), inclusive, of paragraph 4.

(5) Denies all material allegations of fact contained in subparagraphs (1) (a) to (5) (c), inclusive, of paragraph 5.

Denies generally and specifically each and every allegation of the petition not hereinbefore admitted, qualified, or denied.

14 Wherefore, it is prayed that the appeal be denied.

(Signed) C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

Of counsel:

MAXWELL E. MCDOWELL,
Special Attorney, Bureau of Internal Revenue.

Now, March 14, 1931, the foregoing answer certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals

HENRY HARMEL, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 38,855. Promulgated March 24, 1920

The petitioner in 1924 executed oil and gas leases covering land owned by him. The leases provided, in addition to the usual royalty, for a cash consideration which was paid to the petitioner in that year. Held, that the leases were not sales of capital assets within the meaning of section 208 of the Revenue act of 1924, and that the petitioner is not entitled to the benefits of that section.

Robert Ash, Esq., for the petitioner.

J. Arthur Adams, Esq., for the respondent.

The respondent, by deficiency letter dater April 4, 1928,
15 asserted deficiencies in tax against the petitioner in the amount of $2,587.24 for 1924 and $367.68 for 1926, and determined an overassessment in the amount of $727.78 for the year 1925. It is alleged in the petition that the petitioner's tax liability for the three years mentioned is in controversy. At the hearing counsel for the petitioner abandoned the proceeding in so far as it involves the year 1926, and as to the year 1925 the proceeding was dismissed for lack of jurisdiction on the part of the board to hear and determine it.

FINDINGS OF FACT

The petitioner is an individual residing at Megargel, Texas. In the year 1924 the petitioner was, and had been for many years, the owner in fee simple of certain lands. In October, 1924, he executed two oil and gas leases covering said land on the basis of stipulated royalties and a cash consideration of $57,000.

In December, 1924, the petitioner's funds in the First State Bank of Megargel, Texas, became depleted and he, or his agent, on December 5, 1924, deposited in said bank to the account of the petitioner a check for $1,000 drawn on the First National Bank of Wichita Falls. On December 24, 1924, the petitioner or his agent deposited in said First State Bank of Megargel to the account of the petitioner a check for $500 drawn on the First National Bank of Wichita Falls. The said checks drawn on the First National Bank of Wichita Falls were against deposits made by the petitioner from the consideration received on the execution of the oil and gas leases mentioned.

The petitioner filed an income-tax return for 1924 and treated said amount of $57,000 as capital gain. The respondent, upon audit of the return, determined that said $57,000 is income at the ordinary rates, and he also added to the petitioner's income the said
16 amount of $1,500 deposited in the First State Bank of Megargel as "unidentified deposits not reported," and determined a deficiency in tax for 1924 in the amount of $2,587.24.

OPINION

MARQUETTE: It is clear that the respondent is in error with respect to the amount of $1,500 deposited by the petitioner in the First State Bank of Megargel, Texas, in December, 1924. These deposits were funds transferred from the bank of Wichita Falls to the bank of Megargel, and represented a part of the $57,000 received by the petitioner on the execution of certain oil and gas leases, which had already been included in the petitioner's income. The amount in question should be eliminated from the petitioner's income for 1924 as heretofore determined by the respondent.

The only other question is whether the cash consideration received by the petitioner in 1924 as a part of the consideration for the execution of certain oil and gas leases should be taxed as ordinary income or as capital gain, under the provisions of section 208 of the revenue act of 1924. This question has been considered by the board on a number of occasions and has been exhaustively discussed in Henry L. Berg et al. (6 B. T. A. 1287), John T. Burkett (7 B. T. A. 560), and James R. Parkey et al. (16 B. T. A. 441). In the last-named case it is stated:

"In John T. Burkett (7 B. T. A. 560) we were again confronted with the same question presented in the Berg case and with the same contention that the State law prevails. Following the Berg decision we again held that an ordinary oil and gas lease did not convey
17 title to the oil and gas and that such a lease did not constitute a sale of a capital asset within the meaning of section 207 of the revenue act of 1921. It is pertinent to point out that the Burkett case resembles these proceedings in that in addition to the usual royalty there was paid a cash consideration of $175,000.

"It is clear under the above authorities that petitioner James R. Parkey is not entitled to the benefits of section 206 of the revenue act of 1921 and of section 208 of the revenue act of 1924."

The Burkett case was affirmed by the Circuit Court of Appeals for the Eighth Circuit. (31 Fed. (2d) 667.) The court said:

"The gist of this instrument is that for a payment of $175,000 the oil company was given the right to prospect and produce the oil for a maximum term of 50 years under the conditions and upon the payments set forth therein.

"Whether this instrument can be described by any defined legal terms, such as lease, license, etc., it is certain that it is only a limited grant of a right in respect to land and for a limited period of time by one having the fee and possession. Such cannot be denominated a 'sale' in the ordinary sense of that word, and there is no reason to construe section 206 as using 'sale' in any other sense. The wording and the legislative history of section 206 are clear that it was intended to apply to 'sales' in the sense of conveyance of title to property, not of the creation of privileges or estates or rights in property for a limited period of time."

On the authority of the decisions cited we hold that the
18 leases executed by the petitioner did not constitute a sale of capital assets, and that he is not entitled to the benefit of section 208 of the Revenue Act of 1924.

Judgment will be entered under rule 50.

Now, March 14, 1931, the foregoing findings of fact and opinion certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals, Washington

Docket No. 38855

HENRY HARMEL, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Decision

Pursuant to opinion and findings of fact promulgated March 24, 1930, the respondent herein, to wit, on April 5, 1930, having filed a proposed redetermination for the years 1924 and 1926, and the petitioner on April 21, 1930, having filed notice of acquiescence to the said proposed redetermination, it is

Ordered and decided that there are deficiences for the years 1924 and 1926 in the amounts of $2,167.25 and $367.68, respectively.

(Signed) JOHN J. MARQUETTE,
Member.

19 Enter: Entered Apr. 25, 1930.
vlh.

Now, March 14, 1931, the foregoing decision certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

In United States Circuit Court of Appeals, Fifth Circuit

Petition for review of decision of the United States Board of Tax Appeals

Filed Oct. 25, 1930

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Fifth Circuit:

Henry Harmel, in support of this, his petition, filed in pursuance of the provision of section 1001 of the act of Congress approved February 26, 1926, entitled the "Revenue Act of 1926," for the review of the decisions of the United States Board of Tax Appeals rendered on the 25th day of April, 1930, approving a deficiency in income taxes of the petitioner for the calendar year 1924 in the amount of $2,167.25, respectfully shows to this honorable court as follows:

I

1. On May 23, 1928, petitioner filed with the United States Board of Tax Appeals, in pursuance of the revenue act of 1926, his petition requesting the redetermination of a deficiency in income
20 taxes for the calendar year 1924. The facts insofar as material to the questions herein presented were found by the board to be:

"The petitioner is an individual residing at Megargel, Texas. In the year 1924 the petitioner was, and had been for many years, the owner in fee simple of certain lands. In October, 1924, he executed two oil and gas leases covering said land on the basis of stipulated royalties and a cash consideration of $57,000.

"The petitioner filed an income-tax return for 1924 and treated said amount of $57,000 as capital gain. The respondent, upon audit of the return, determined the said $57,000 is income at the ordinary rates * * *."

2. On March 24, 1930, the board rendered an opinion on these facts and held:

"The only other question is whether the cash consideration received by the petitioner in 1924 as a part of the consideration for the execution of certain oil and gas leases should be as ordinary income or as capital gain, under the provisions of section 208 of the revenue act of 1924. This question has been considered by the board on a

number of occasions and has been exhaustively discussed in Henry L. Berg et al. (6 B. T. A. 1287), John T. Burkett (7 B. T. A. 560), and James R. Parkey et al. (16 B. T. A. 441). In the last-named case it is stated:

"'In John T. Burkett (7 B. T. A. 560), we were again confronted with the same question presented in the Berg case and with the same contention that the State law prevails. Following the Berg decision,

21 we again held that an ordinary oil and gas lease did not convey title to the oil and gas and that such a lease did not constitute a sale of a capital asset within the meaning of section 208 of the revenue act of 1921. It is pertinent to point out that the Burkett case resembles these proceedings in that in addition to the usual royalty there was paid a cash consideration of $175,000.

"'It is clear under the above authorities that petitioner James R. Parkey is not entitled to the benefits of section 206 of the revenue act of 1921 and of section 208 of the revenue act of 1924.'

"The Burkett case was affirmed by the Circuit Court of Appeals for the Eighth Circuit. (31 Fed. (2d) 667.) The court said:

"'The gist of this instrument is that for a payment of $175,000 the oil company was given the right to prospect and produce the oil for a maximum term of 50 years under the conditions and upon the payments set forth therein.

"'Whether this instrument can be described by any defined legal terms, such as lease, license, etc., it is certain that it is only a limited grant of a right in respect to land and for a limited period of time by one having the fee and possession. Such can not be denominated a "sale" in the ordinary sense of that word, and there is no reason to construe section 206 as using "sale" in any other sense. The wording and the legislative history of section 206 are clear that it was intended to apply to "sales" in the sense of conveyance of title to property, not of the creation of privileges or estates or rights in property for a limited period of time.'

"On the authority of the decisions cited we hold that the leases executed by the petitioner did not constitute a sale of capital assets, and that he is not entitled to the benefit of section 208 of the revenue act of 1924."

22 3. On the 25th day of April, 1930, the said board rendered its decision, approving a deficiency against the petitioner in the amount of $2,167.25 for the year 1924.

II

DESIGNATION OF COURT OF REVIEW

The petitioner being aggrieved by the said opinion and decision, and being an individual, desires a review thereof in accordance with section 1002 (a) of the review act of 1926, by the United States Circuit Court of Appeals for the Fifth Circuit, whereof he is an inhabitant.

III

ASSIGNMENT OF ERROR

The petitioner, as a basis of review, makes the following assignment of error:

1. The Board of Tax Appeals erred in ruling and/or finding that bonuses received for executing oil and gas leases in Texas are not taxable as capital gain.

Wherefore, the petitioner prays that the decision of the Board of Tax Appeals entered against him be reversed, and that the court grant such other and further relief as the court may deem meet and proper in the premises.

HENRY HARMEL,
Petitioner.

By ROBERT ASH,
T. J. REILLY,
Attorneys for Petitioner,
Munsey Building, Washington, D. C.

23 [*Duly sworn to by Robert Ash; jurat omitted in printing.*]

Now, March 14, 1931, the foregoing petition for review certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before U. S. Board of Tax Appeals

Præcipe for transcript of record

Filed Oct. 25, 1930

To the Clerk of the United States Board of Tax Appeals:

You will please prepare and on or before ———, 1930, transmit to the clerk of the United States Circuit Court of Appeals for the Fifth Circuit certified copies of the following documents in the above-entitled case:

24 1. Docket entries of proceedings before the United States Board of Tax Appeals.
2. Petition.
3. Answer.
4. Findings of fact and opinion of the board.
5. Decision (order of redetermination) of the board.
6. Petition for review to the United States Circuit Court of Appeals for the Fifth Circuit.
7. This designation of record.

The foregoing to be prepared, certified, and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Fifth Circuit.

ROBERT ASH,
T. J. REILLY,
Attorneys for Petitioner,
Munsey Building, Washington, D. C.

Now, March 14, 1931, the foregoing præcipe certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

25 In United States Circuit Court of Appeals, Fifth Circuit

[Title omitted.]

Stipulation as to leases

It is hereby stipulated by and agreed between G. A. Youngquist, Assistant Attorney General, and Robert Ash, attorney for Henry Harmel, that this stipulation and the following documents should be incorporated in the transcript of record in the above-entitled cause:

1. Copy of lease dated October 13, 1924, between Henry Harmel and E. R. Fain.
2. Copy of lease dated October 21, 1924, between Henry Harmel and J. A. Gardner.

G. A. YOUNGQUIST,
Assistant Attorney General.
ROBERT ASH,
Attorney for Petitioner.

JUNE 29, 1931.

Exhibit to stipulation

OIL AND GAS LEASE

Agreement, made and entered into the 13th day of October, 1924, by and between Henry Harmel, of Archer County, Texas, hereinafter called lessor (whether one or more), and E. R. Fain, hereinafter called lessee:

Witnesseth: That the said lessor, for and in consideration of twenty thousand and no/100 dollars and other consideration
26 hereinafter set forth, cash in hand paid, the receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of the lessee to be paid, kept, and performed, has granted, demised, leased, and let, and by these presents does grant, lease, and let unto the said lessee for the sole and

only purpose of mining and operating for oil and gas and of laying pipe lines and of building tanks, power stations, and structures thereon to produce, save, and take care of said products, all that certain tract of land situated in the county of Archer, State of Texas, described as follows, to wit:

The west forty acres of the south one-half of T. E. & L. Co. survey No. 2401, with metes and bounds as follows, viz: Beginning at the southwest corner of said survey No. 2401; thence along west boundary line to a point in said line which is the southwest corner of an eighty-acre lease made to E. R. Fain on Sept. 8, 1924; thence east with the south boundary line of said eighty-acre lease 933⅓ feet to stake for corner; thence south to the south boundary line of said survey No. 2401; thence west to the place of beginning; ——— and containing 40 acres more or less.

It is agreed that this lease shall remain in force for a term of three years from this date, and as long thereafter as oil or gas, or either of them, is produced from said land by the lessee.

In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of lessor, free of cost, in the pipe line to which he may connect his wells, the equal of one-eighth part of all oil produced and saved from the leased premises.

27 2. To pay the lessor ⅛ value at wells ——— dollars each year in advance for the gas from each well where gas only is found, while the same is being used off the premises, and lessor to have gas free of cost from any such well for all stoves and all inside lights in the principal dwelling house on said land during the time by making his own connections with the well at his own risk and expense.

3rd. To pay lessor for gas produced from any oil well and used off the premises at the rate of ⅛ value at wells for such gas ——— dollars per year, for the time during which such gas shall be used, said payments to be made each three months in advance. Should the lessee desire to utilize casing-head gas coming from oil wells upon the premises herein described for the purpose of manufacturing gasoline, lessee shall have the privilege of so doing by paying to the lessor one ⅛ of the proceeds derived from the sale of said casing-head gas at the wells.

If no well be commenced on said land on or before the 13th day of October, 1925, this lease shall terminate as to both parties, unless the lessee on or before that date shall pay or tender to the lessor, or to the lessor's credit in the First State Bank at Megargel, Texas, or its successors, which shall continue as the depository, regardless of changes in the ownership of said land, the sum of eighty and no/100 dollars, which shall operate as rental and cover the privilege of deferring the commencement of a well for twelve months from said date. In like manner and upon like payments or tenders the commencement of a well may be further deferred for like periods of the same number of months successively. And it is understood and agreed that the consideration first recited herein, the down payment,

covers not only the privilege granted to the date when said first rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid, and any and all other rights conferred.

28 Should the first well drilled on the above-described land be a dry hole, then and in that event, if a second well is not commenced on said land within twelve months thereafter, this lease shall terminate as to both parties, unless the lessee on or before the expiration of said twelve months shall resume the payments of rentals in the same amount and in the same manner as hereinbefore provided. And it is agreed that upon the resumption of the payments of rentals, as above provided, that the last preceding paragraph hereof, governing the payment of rentals and the effect thereof, shall continue in force just as though there had been no interruption in the rental payments.

If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said lessor only in proportion which his interest bears to the whole and undivided fee.

Lessee shall have the right to use, free of cost, gas, oil and water produced on said land for all operations thereon, except water wells of lessor.

When requested by lessor, lessee shall bury pipe line below plow depth.

No well shall be drilled nearer than 200 feet to the house or barn now on said premises without the written consent of the lessor.

Lessee shall pay for damages caused by all operations to growing crops on said land.

Lessee shall have the right at any time to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing.

If the estate of either party hereto is assigned—and the privilege of assigning in whole or in part is expressly allowed—the cove-

29 nants hereof shall extend to their heirs, executors, administrators, successors, or assigns, but no change in the ownership of the land or assignment of rentals or royalties shall be binding on the lessee until after the lessee has been furnished with a written transfer or assignment, or a copy thereof; and it is hereby agreed that in the event that this lease shall be assigned as to a part or as to parts of the above described lands and the assignee or assignees of such part or parts shall fail or make default in the payment of the proportionate part of the rents due from him or them, such default shall not operate to defeat or affect this lease so far as it covers a part or parts of said lands upon which the said lessee or any assignee thereof shall make due payment of said rental.

Lessor hereby warrants and agrees to defend the title to the lands herein described and agrees that the lessee shall have the right at any time to redeem for lessor, by payment, any mortgages, taxes, or other liens on the above described lands, in the event of default of payment by lessor, and be subrogated to the rights of the holder thereof.

The other consideration above mentioned is the sum of $20,000.00, which shall be paid to the lessor hereof out of one-half of seven-eights of the first oil produced on said land.

In testimony whereof, we sign, this the 13th day of October, 1924.

——— ———.

——— ———.

Witnesses:

——— ———.

——— ———.

U. S. Board of Tax Appeals, div. 1, docket 38855. Admitted in evidence Nov. 27, 1929. Petitioner's Exhibit 1.

30 *Exhibit to stipulation*

OIL AND GAS LEASE

Agreement, made and entered into the 21st day of October, 1924, by and between Henry Harmel, of Archer County, Texas, party of the first part, hereinafter called lessor (whether one or more), and J. A. Gardner, party of the second part, hereinafter called lessee.

Witnesseth: That the said lessor, for and in consideration of forty-four thousand and no/100 dollars, cash in hand paid, and the consideration hereinafter named, receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of lessee to be paid, kept, and performed, has granted, conveyed, demised, leased, and let, and by these presents do grant, convey, demise, lease, and let unto the said lessee, for the sole and only purpose of mining and operating for oil and gas and of laying pipe lines and of building tanks, powers, stations, and structures thereon to produce, save, and take care of said products, all that certain tract of land situated in the county of Archer, State of Texas, described as follows, to wit:

The west eighty acres of land out of the east one hundred twenty acres of land of the south one-half of T. E. & L. Co. survey No. 2401; the north boundary line of said eighty acres being the south boundary line of a lease heretofore made in favor of E. R. Fain out of the north one-half of said survey, Abstract No. 581, and containing eighty acres, more or less.

It is agreed that this lease shall remain in force for a term of three years from this date, and as long thereafter as oil or gas, or either of them, is produced from said land by lessee.

In consideration of the premises the said lessee covenants and agrees:

31 1. To deliver to the credit of lessor, free of cost, in the tanks or pipe line to which he may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises.

2. To pay the lessor one-eighth value at wells ——— dollars each year in advance, for the gas from each well where gas only is found, while the same is being used off the premises, and lessor to have gas

free of cost from any such well for all stoves and all inside lights in the principal dwelling house on said land during the same time by making his own connection with the well at his own risk and expense.

3. To pay lessor for gas produced from any oil well and used off premises at the rate of ⅛ value at wells for such gas ——— dollars per year, for the time during which such gas shall be used, said payments to be made each three months in advance.

If no well is commenced on said land on or before the 21st day of Oct., 1925, this lease shall terminate as to both parties, unless on or before that date lessee shall pay or tender to the lessor, or to the lessor's credit in the First State Bank at Megargel, Texas, or its successors, which shall continue as the depository regardless of changes in the ownership of said land, the sum of one hundred sixty and no/100 dollars, which shall operate as a rental and cover the privilege of deferring the commencement of a well for twelve months from said date. In like manner and upon like payments or tenders the commencement of a well may be further deferred for like period of the same number of months successively. And it is understood and agreed that the consideration first recited herein, the down payment covers not only the privileges granted to the date when said first rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid, and any and all other rights conferred.

32 Should the first well drilled on the above-described land be a dry hole, then and in that event, if a second well is not commenced on said land within twelve months from the expiration of the last rental period for which rental has been paid this lease shall terminate as to both parties, unless the lessee on or before the expiration of said twelve months shall resume the payments of rentals in the same amount and in the same manner as hereinbefore provided. And it is agreed that upon the resumption of the payments of rentals, as above provided, that the last preceeding paragraph hereof, governing the payment of rentals and the effect thereof, shall continue in force just as though there had been no interruption in the rental payments.

If said lessor owns a less interest in the above-described land than the entire and undivided fee-simple estate therein, the royalties and rentals herein provided for shall be paid to the lessor only in proportion which his interest bears to the whole and undivided fee.

Lessee shall have the right to use, free of cost, gas, oil, and water produced on said land for its operations thereon, except water from wells of lessor.

When requested by lessor, lessee shall bury his pipe line below plow depth.

No well shall be drilled nearer than 200 feet to the house or barn now on said premises without the consent of the lessor.

Lessee shall pay for damages caused by his operations to growing crops on said land.

Lessee shall have the right at any time to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing.

33 If the estate of either party hereto is assigned—and the privilege of assigning in whole or in part is expressly allowed—the covenants hereof shall extend to the assigns and successive assigns, but no change in the ownership of the land or assignment of rentals or royalties shall be binding on the lessee until after the lessee has been furnished a written transfer or assignment or a true copy thereof; and it is hereby agreed that in the event that this lease shall be assigned as to a part or as to parts of the above-described lands, and the assignee or assignees of such part or parts shall fail or make default in the payment of the proportionate part of the rents due from him or them, such default shall not operate to defeat or affect this lease in so far as it covers a part or parts of said lands upon which the said lessee or any assignee thereof shall make due payment of said rental.

Lessor hereby warrants and agrees to defend the title to the lands herein described and agrees that the lessee shall have the right at any time to redeem for lessor, by payment, any mortgage, taxes, or other liens on the above-described lands, in the event of default in payment by lessor, and be subrogated to the rights of the holder thereof.

In addition to the cash consideration above mentioned, a further consideration of forty-four thousand dollars is to be paid by lessee to the lessor hereof out of one-half of seven-eighths of the first oil produced from said land, and a vendor's lien is retained against said leasehold estate and the oil produced therefrom until the full sum of forty-four thousand dollars is paid. It is further agreed by the parties hereto that lessee shall drill two wells on the said eighty-acre tract to the depth of the pay sand found in this field, the first well to be begun on or before fifteen days from the

34 date hereof and the second well to be begun on or before forty-five days from the date hereof, anything in this contract to the contrary notwithstanding. It is further agreed that in the event lessee shall fail or refuse to begin the drilling of either of the wells above specified in the time specified or shall fail to drill either well to the depth specified, then this contract shall forfeit and shall become null and void and shall revert to the lessor hereof.

It is agreed by the parties hereto that lessee shall begin actual drilling operations on the above-described land within 10 days from the date hereof. In the event lessee shall not begin actual drilling operation on or before the expirations of said ten days this contract shall terminate as to all parties and the $20,000.00 cash consideration shall remain the property of lessor as liquidated damages.

U. S. Board of Tax Appeals, div. 1, docket 38855. Admitted in evidence Nov. 27, 1929. Petitioner's Exhibit 2.

No. 6212. United States Circuit Court of Appeals, Fifth Circuit. Henry Harmel, petitioner, vs. Commissioner of Internal Revenue, respondent. Stipulation.

Now, June 26, 1931, the foregoing petitioner's Exhibits Nos. 1 and 2 certified from the record as true copies.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

35 [Minute entry of argument and submission, Feb. 16, 1932, omitted in printing.]

36 In United States Circuit Court of Appeals for the Fifth Circuit

No. 6212

HENRY HARMEL, PETITIONER

versus

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for review of decision of the U. S. Board of Tax Appeals (District of Texas)

(February 23, 1932)

Before BRYAN, FOSTER, and WALKER, Circuit Judges

Opinion

Filed February 23, 1932

BRYAN, Circuit Judge: This is a petition by a taxpayer to review a decision of the Board of Tax Appeals which held that $57,000, received in 1924 as cash consideration for an oil and gas lease of land in Texas, was taxable as ordinary income. The taxpayer contended that the amount so received should have been taxed as capital gain under § 208a (1), revenue act of 1924, which provides: "The term 'capital gain' means taxable gain from the sale or exchange of capital assets."

The same question was decided in favor of a taxpayer by this court in Ferguson v. Commissioner (45 F. (2) 573), and we
37 see no reason to reverse our ruling in that case. We there held that in Texas, however it might be in other States, an oil and gas lease conveyed a determinable fee to those minerals in place, and that this local rule of property was controlling in the absence of congressional legislation restricting the meaning of the word "sale." Since then the Supreme Court, in group No. 1 Oil Corporation v. Bass 283 U. S. 279), following Theisen v. Robison (117 Tex. 489), likewise has held that an oil and gas lease constitutes a present sale of

the oil and gas in place, under the constitution and law of Texas. It is no new doctrine that a rule of property prevailing in a State, and changes in that rule, will be recognized in administering the Federal income tax law. (United States v. Robbins, 269 U. S. 315; United States v. Malcolm, 282 U. S. 792. See also the community income-tax cases of Poe v. Seaborn, 282 U. S. 101; Goodell v. Koch, 282 U. S. 118; Hopkins v. Bacon, 282 U. S. 122; Bender v. Pfaff, 282 U. S. 217.)

The petition for review is granted, and the cause remanded for further proceedings not inconsistent with this opinion.

38 In United States Circuit Court of Appeals

No. 6212

HENRY HARMEL

versus

COMMISSIONER OF INTERNAL REVENUE

Judgment

February 23, 1932

This cause came on to be heard on the petition of Henry Harmel for a review of a decision of the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged, and decreed by this court that said petition be, and the same is hereby granted; and that this cause be, and it is hereby, remanded to the said United States Board of Tax Appeals for further proceedings not inconsistent with the opinion of this court.

39 In United States Circuit Court of Appeals for the Fifth Circuit

[Title omitted.]

Motion for order staying mandate filed

March 14, 1932

Now comes the respondent in the above-entitled cause, by C. M. Charest, General Counsel, Bureau of Internal Revenue, his attorney, and moves the court for a stay of mandate herein for a period of three months, pending an application for certiorari to the Supreme Court of the United States.

(Signed) C. M. CHAREST,
General Counsel, Bureau of Internal Revenue,
Attorney for respondent.

40 In United States Circuit Court of Appeals for the Fifth Circuit

[Title omitted.]

Order staying mandate

March 14, 1932

On consideration of the application of the respondent in the above numbered and entitled cause for a stay of the mandate of this court therein, to enable respondent to apply for and to obtain a writ of certiorari from the Supreme Court of the United States, it is ordered that the issue of the mandate of this court in said cause be, and the same is, stayed for a period of thirty days; the stay to continue in force until the final disposition of the case by the Supreme Court, provided that within thirty days from the date of this order there shall be filed with the clerk of this court the certificate of the clerk of the Supreme Court that the certiorari petition and record have been filed, and that due proof of service of notice thereof under paragraph 3 of rule 38 of the Supreme Court has been given. It is further ordered that the clerk shall issue the mandate upon the filing of a copy of an order of the Supreme Court denying the writ or upon the expiration of thirty days from the date of this order, unless the above-mentioned certificate shall be filed with the clerk of this court within that time.

Done at New Orleans, La., this 14th day of March, 1932.

(Signed) N. P. BRYAN,
United States Circuit Judge.

41 [Clerk's certificate to foregoing transcript omitted in printing.]

42 Supreme Court of the United States

Order allowing certiorari

Filed April 18, 1932

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Indorsement on cover:] Enter. Attorney General. File No. 36638. U. S. Circuit Court of Appeals, Fifth Circuit, term No. 824. David Burnet, Commissioner of Internal Revenue, petitioner, vs. Henry Harmel. Petition for a writ of certiorari and exhibit thereto. Filed March 24, 1932. File No. 36638.

U. S. GOVERNMENT PRINTING OFFICE: 1932

FILE COPY

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No. [redacted] 26

In the Supreme Court of the United States

OCTOBER TERM, 1931

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HENRY HARMEL

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1931

No. —

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

HENRY HARMEL

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the petitioner, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit in the above case entered February 23, 1932 (R. 36), granting a petition to review and reversing the decision of the United States Board of Tax Appeals (R. 18). The opinion of the court below (R. 35) is not yet reported. The opinion of the Board of Tax Appeals (R. 16) is reported in 19 B. T. A. 376. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether cash bonuses paid as advance royalties under oil and gas leases on lands in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924.

STATUTE INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 262 (U. S. C., Title 26, Sec. 939):

> SEC. 208. (a) For the purposes of this title—
>
> (1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;
>
> (2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets;
>
> (3) The term "capital deductions" means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;
>
> (4) The term "ordinary deductions" means the deductions allowed by section 214 other than capital losses and capital deductions;
>
> (5) The term "capital net gain" means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount,

if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term "capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain;

(7) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term "capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected, and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain.

STATEMENT

The petitioner is an individual residing at Megargel, Texas. In the year 1924 the petitioner was, and had been for many years, the owner in fee simple of certain lands. In October, 1924, he executed two oil and gas leases covering said land on the basis of stipulated royalties and a cash consideration of $57,000. (R. 15.) This cash payment was returned by petitioner as gain from sales of capital assets under Section 208, Revenue Act of 1924. The Commissioner treated it as income taxable at the ordinary rates. (R. 9.) The Board of Tax Appeals held with the Commissioner (R. 18), and the Circuit Court of Appeals reversed the Board (R. 35).

The two oil leases referred to above are set out in full in the record. (R. 25–34.)

SPECIFICATION OF ERRORS TO BE URGED

1. The court below erred in holding that cash bonuses paid as advance royalties for the execution of oil and gas leases in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924.

2. The court below erred in holding that in determining the questions presented it was bound by the decisions of the Texas courts that leases of oil lands constitute sales of the oil.

3. The court below erred in reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The court below held that the cash bonuses received by respondent were gain from the sale of capital assets and not ordinary income, and followed its earlier decision in *Ferguson* v. *Commissioner,* 45 F. (2d) 573. It concluded that it was bound to reach this result because under the decisions of the highest court of Texas leases of oil lands, such as those involved in this case, are regarded as sales of oil in place. The decision of the court below is in conflict with the decision of the Court of Claims in *Hirschi* v. *United States,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576, where a similar cash payment in connection with a lease of oil lands in Texas was regarded as ordinary income taxable at the ordinary rates.

A bonus paid for the execution of an oil and gas lease is advance royalty. *Work* v. *Mosier,* 261 U. S. 352. The conclusion of the court below that royalties are to be treated as proceeds of the sale of capital assets is in conflict with the decisions of this Court in *Stratton's Independence* v. *Howbert,* 231 U. S. 399; *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103, 114; *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 521–522; *United States* v. *Biwabik Mining Co.,* 247 U. S. 116, 125–126, and is also in conflict with *Burkett* v. *Commissioner,* 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Berg* v. *Commissioner,* 33 F. (2d) 641 (App. D. C.), certiorari denied, 280 U. S. 598; *Murphy* v. *Commissioner* (App. D. C.), decided February 20, 1930,

without opinion on authority of the *Berg* case, *supra,* 2 Prentice Hall 1930, p. 1963, not otherwise reported; *Reynolds* v. *Commissioner* (App. D. C.), decided February 20, 1930, without opinion upon the authority of the *Berg* case, *supra,* 2 Prentice Hall 1930, p. 1963, not otherwise reported; and *Alexander* v. *King,* 46 F. (2d) 235 (C. C. A. 10th), certiorari denied, 283 U. S. 845. None of the cases cited in this paragraph involved the application of peculiar rules of local law.

The fact that under Texas law a lease of oil lands constitutes a sale of the oil is not determinative, and we believe that the court below erred in giving the effect to local law which it did. Realistically viewed in the light of the decisions of this Court and the other authorities, it is submitted that royalties in fact constitute for Federal income tax purposes a form of rental which is ordinary income rather than gain from the sale of capital assets. The only purpose of the capital gain provisions of the statute was to classify income so that gain from the sale or exchange of capital assets would receive preferential treatment over ordinary income where the amount involved was large enough to reach into the higher tax brackets. There is nothing in the statute which indicates that it was the intention of Congress that peculiar local rules should govern the classification, as was the case in *United States* v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55, and *Crooks* v. *Harrelson,* 282 U. S. 55. The present case more nearly resembles *Burk-Waggoner Oil Assn.* v.

Hopkins, 269 U. S. 110, and *Weiss* v. *Wiener,* 279 U. S. 333. Accordingly we believe that the court below erred in treating the local law as dispositive of the question presented in this case. In giving such undue effect to the local rule the decision of the court below conflicts in principle with *Rosenberger* v. *McCaughn,* 25 F. (2d) 699 (C. C. A. 3d), certiorari denied, 278 U. S. 604, and *Bankers Pocahontas Coal Co.* v. *Commissioner* (C. C. A. 4th), decided January 25, 1932, not yet reported, III C. C. H. 1932, p. 8234.

2. The questions presented are of general importance, for they affect every oil lease on lands in the State of Texas in connection with which a bonus is paid. As Texas contains the largest oil-producing fields in the United States, a large number of similar cases are necessarily involved, some of which are already pending before the Board of Tax Appeals and in the Bureau of Internal Revenue. A decision by this Court is necessary for the proper administration of the applicable provisions of the several Revenue Acts.

In view of the conflicts of decisions mentioned and the importance of the questions in the administration of the Federal revenue, it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
Solicitor General.

MARCH, 1932.

U. S. GOVERNMENT PRINTING OFFICE: 1932

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No. 26

In the Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH ~~DISTRICT~~ circuit

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1932

No. 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 20) is reported in 56 F. (2d) 153. The opinion of the Board of Tax Appeals (R. 8–10) is reported in 19 B. T. A. 376.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Fifth Circuit was entered February 23, 1932. (R. 21.) Petition for a writ of certiorari was granted April 18, 1932. Jurisdiction is con-

ferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether cash bonuses paid as advance royalties under oil and gas leases on lands in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924.

STATUTE INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 262:

> SEC. 208 (a) For the purposes of this title—
>
> (1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;
>
> (2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets;
>
> (3) The term "capital deductions" means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;
>
> (4) The term "ordinary deductions" means the deductions allowed by section 214 other than capital losses and capital deductions;
>
> (5) The term "capital net gain" means the excess of the total amount of capital

gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term "capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain;

(7) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term 'capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections

210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain.

* * * * *

(U. S. C., Title 26, Sec. 939.)

STATEMENT

The respondent is an individual residing at Megargel, Texas. In the year 1924 he was, and had been for many years, the owner in fee simple of certain lands (R. 8) in the State of Texas (R. 2). In October, 1924, he executed two oil and gas leases of such lands for terms of three years and as long as oil or gas should be produced from the land by the lessees on the basis of stipulated royalties measured by the lessees' production of oil and gas and a cash consideration of $57,000. (R. 8, 15, 17.) This cash payment was returned by respondent as gain from sales of capital assets, under Section 208 of the Revenue Act of 1924. (R. 9.) The Commissioner of Internal Revenue treated it as income, taxable at the ordinary rates. (R. 5, 9.) The Board of Tax Appeals held with the Commissioner (R. 10), but the Circuit Court of Appeals for the Fifth Circuit reversed the Board (R. 20–21.)

The two oil leases referred to above are set out in full in the record. (R. 14–19.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that cash bonuses paid as advance royalties for the execution of oil and gas leases in

the State of Texas constitute income from the sale of capital assets, within the meaning of Section 208 of the Revenue Act of 1924.

2. In holding that in determining the question presented it was bound by the decisions of the Texas courts that leases of oil lands constitute sales of the oil.

3. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

A cash bonus paid upon the execution of an oil and gas lease is to be treated as advance royalty. The distinction made by the court below between bonus and royalty is unsound and is contrary to the decided cases.

The capital-gains provisions of the statute first appeared in the Revenue Act of 1921. At that time it was settled by the decisions of this Court that royalties are ordinary income and are not to be treated under the Revenue Acts as proceeds from the conversion of capital assets. The statute here involved contains no definition of the term "sale of capital assets" which is decisive. But it is to be presumed that Congress intended to deal only with those transactions which under general law, as it then existed, constituted sales of capital assets. A consideration of the purpose of the legislation supports this conclusion. The classification made in the statute was designed to stimulate "sales" of property which was then being held off the market

because of the burden of taxes theretofore imposed upon "capital gains" accumulated over a number of years and realized upon the "sale" of property which had enhanced in value. Rentals and royalties from oil leases were not within the purpose of the law in reducing taxes upon "capital gains."

The court below erroneously held that decision was controlled by the local rule that such leases as are here involved constitute sales of oil and gas in place. This Court has indicated that local rules may be disregarded in classifying the income from mineral leases, and until the decision below that was thought to be the correct view. It is true that where a Federal statute is so drawn that it either expressly or by necessary implication requires resort to the local law the Federal courts will be guided by the local rule. But that is not the situation here, and the cases relied upon below are therefore distinguishable.

ARGUMENT

I

THE PAYMENTS RECEIVED BY RESPONDENT WERE ADVANCE ROYALTIES

The court below held that the cash bonuses received by respondent under oil and gas leases [1]

[1] These leases were made "for the sole and only purpose of mining and operating for oil and gas and of laying pipe lines and of building tanks, power stations, and structures thereon to produce, save, and take care of said products * * *." (R. 14–15, 17.)

were gains from the sale of capital assets and not ordinary income. This conclusion was based upon its earlier decision in *Ferguson* v. *Commissioner*, 45 F. (2d) 573. In that case a distinction was drawn between a bonus and a royalty, and it was held that the former represented the proceeds from the sale of oil and gas leases, while the latter constituted proceeds from the retained interest of the lessor which came to him from time to time as revenue under the contract.

We are unable to apprehend any sound basis for this distinction. The consideration for the lease is the cash bonus and the future royalties. Apparently the court below was impelled to make the distinction because of a misconception which it entertained as to the scope of the depletion allowance. It assumed that a depletion allowance was not made to the lessor with respect to the bonus, while such an allowance was made with respect to the royalty, so that (p. 577) "this part of his capital is protected and returned." The assumption that no depletion allowance was permitted with respect to the bonus is clearly erroneous. See Article 216, Treasury Regulations 65, as amended by T. D. 3938, V–2 C. B. 117; *Murphy Oil Co.* v. *Commissioner*, now pending in this Court, No. 80, October Term, 1932.

Nor is the distinction made below between a bonus and a royalty supported by the cases cited.[2] In every case which has been found where the question was presented it has been held that a bonus does not differ from a royalty, but, on the contrary, constitutes a part of the royalty which is paid in advance. The leading case on this point is *Work* v. *Mosier,* 261 U. S. 352, where this Court held that a bonus paid for an oil and gas lease on Indian land was (pp. 357–358) "part of the royalty or rental in a lump sum * * *."

The court below distinguished that case by treating it as announcing a rule applicable only to its peculiar facts. But this Court's discussion of the nature of a bonus does not indicate that it was limited to the particular bonus there involved and that other bonuses should be regarded differently. This Court there said (pp. 357–358):

> The bonus which was the result of bidding for desirable and profitable oil and gas leases secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was in effect a supplement to the royalties already determined. It was really part of the royalty or rental in a lump sum or down payment. We do not see how it can

[2] *Texas Co.* v. *Daugherty,* 107 Tex. 226; *Stephens County* v. *Oil & Gas Co.,* 113 Tex. 160; *Humphreys-Mexia Oil Co.* v. *Gammon,* 113 Tex. 247, 255; *Waggoner Estate* v. *Sigler Oil Co.,* 118 Tex. 509.

> be classified as anything else. It was income from the use of the mineral resources of the land. Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the product of the mine. What was intended to be distributed to the members of the tribe was the income from the mineral deposits in their lands, and the bonus was part of that. Doubtless Congress had in mind regular annual or quarterly equal payments when it used the word royalties; and did not anticipate such large down payments. But in the unexpected event, we must decide under what head the bonus is to be treated, whether as capital or income, and it seems clear to us that, in view of the entire statute, it is more aptly described by the latter term.

We submit that this Court did not reach the conclusion that bonuses were advance royalties because of any peculiar provision of the statute involved, but because they constituted "income from the use of the mineral resources of the land" (p. 358). The question was squarely presented whether a bonus should be classified as capital derived from a disposition of property or as income paid for the use thereof. Under Section 4, Second, of the Osage Allotment Act (34 Stat. 544), it was the "royalty" received from the leases which was to be distributed to the individual members of the tribe. This Court held (p. 358) that "What was

intended to be distributed to the members of the tribe was the income from the mineral deposits in their lands, and the bonus was part of that." The statute did not make the classification, and this Court, in accordance with general principles of law, held that such bonus was not capital, but income.

The controlling authority of *Work* v. *Mosier, supra,* has been uniformly recognized wherever the distinction between bonus and royalty was sought to be made. *Alexander* v. *King,* 46 F. (2d) 235 (C. C. A. 10th), certiorari denied, 283 U. S. 845; *W. M. Ferguson* v. *Commissioner* (C. C. A. 10th), decided June 30, 1932, reported in 323 C. C. H. 9062; *Appeal of Nelson Land & Oil Co.,* 3 B. T. A. 315, 326. The court below stands alone in making a distinction between bonus and royalty. It is not made in the following cases, which do not cite *Work* v. *Mosier: Burkett* v. *Commissioner,* 7 B. T. A. 560, affirmed, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Berg* v. *Commissioner,* 33 F. (2d) 641 (App. D. C.), certiorari denied, 280 U. S. 598; *Hirschi* v. *United States,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576. The latter case also dealt with an oil lease of Texas lands, and its decision is squarely opposed to the instant decision.

Support for the view that a bonus is to be treated as an advance royalty is also to be found in the decision of this Court in *United States* v. *Biwabik Mining Co.,* 247 U. S. 116. The distinction between bonus and royalty was not there in issue, but the

Court tacitly assumed that they were not different and treated them alike, quoting from the opinion of the District Court as follows (p. 121):

> The defendant paid $612,000 for the lease under consideration and in addition assumed the payment of the royalties stipulated for therein. This may properly and justly be considered a payment in advance of an increased royalty on ore to be mined, and that is precisely the character which the defendant gave to the payment when dealing with it in its private accounts * * *.

Our contention that a bonus is advance royalty is also supported by decisions in cases where lessee taxpayers have sought to deduct the entire bonus (under leases other than oil leases) as a business expense in the year in which paid. It has uniformly been held in such cases by the Bureau of Internal Revenue,[3] by the Board of Tax Appeals,[4] and

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[3] Article 109, Treasury Regulations 45 and 62; Article 110, Treasury Regulations 65 and 69; Article 130, Treasury Regulations 74; I. T. 1711, II–2 C. B. 104; A. R. R. 6459, III–1 C. B. 138.

[4] *Nelson Land & Oil Co.*, 3 B. T. A. 315, 325–326; *Burkett* v. *Commissioner*, 7 B. T. A. 560, affirmed, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Hazlett* v. *Commissioner*, 10 B. T. A. 332, 337; *Parkey* v. *Commissioner*, 16 B. T. A. 441, 445; *Baton Coal Co.* v. *Commissioner*, 19 B. T. A. 169, affirmed, 51 F. (2d) 469, (C. C. A. 3d), certiorari denied, 284 U. S. 674; *Ferguson* v. *Commissioner*, 20 B. T. A. 130, 131, reversed, 45 F. (2d) 573 (C. C. A. 5th). Cf. *Waggoner* v. *Commissioner*, 24 B. T. A. 657.

by the courts[8] that such a bonus is advance rental or royalty and that the deduction must be taken over the life of the lease.

II

SINCE A BONUS IS ADVANCE RENTAL OR ROYALTY, THE PAYMENTS RECEIVED BY RESPONDENT SHOULD BE CLASSIFIED AS ROYALTIES AND RETURNED AS ORDINARY INCOME

This Court has repeatedly held that royalties from oil and gas leases are not to be treated under the Revenue Acts as proceeds from the conversion of capital assets. In 1913 this Court held in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, that the profit realized from mines by operating owners was income within the meaning of the excise tax laid upon corporations and measured by their income. Section 38, Act of August 5, 1909, c. 6, 36 Stat. 11, 112. This conclusion was reaffirmed in 1918 in *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126. In 1916 the same conclusion was reached in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 114,

[8] *Central Nat. Bank of Tulsa, Okla.*, v. *United States*, 283 Fed. 368, 373 (C. C. A. 8th), dismissed, 264 U. S. 600; *J. Alland & Bro. Inc.* v. *United States*, 28 F. (2d) 792 (Mass.); *Hirschi* v. *United States*, 67 C. Cls. 637; *Burkett* v. *Commissioner*, *supra*; *Baton Coal Co.* v. *Commissioner*, *supra*; *Galatoire Bros.* v. *Lines*, 23 F. (2d) 676 (C. C. A. 5th). See *Constantine* v. *Wake*, 1 Sweeny 239, 244 (N. Y.); Klein, Federal Income Taxation, p. 439; *Crile* v. *Commissioner*, 55 F. (2d) 804 (C. C. A. 6th). Cf. *Jennings & Co. Inc.* v. *Commissioner*, 59 F. (2d) 32 (C. C. A. 9th).

under the income-tax section of the Tariff Act of October 3, 1913, c. 16, 38 Stat. 114, 166, 181.

While *Stratton's Independence* v. *Howbert* and *Stanton* v. *Baltic Mining Co.* related to the income of operating owners, the same rule was applied to lessors in 1917 in *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, where it was held that royalties received by lessors of iron-ore land constituted income under the 1909 Act and not payments for the sale of ore. The principle of the *Sargent Land Co. case* was applied to a lessee in 1918, and the receipts from a similar lease were held to be taxable income. In *United States* v. *Biwabik Mining Co., supra,* with respect to the rights of the lessee under the lease, it was said (pp. 125–126):

> The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of lease here involved so long as he sees fit to hold the same without exercising the privilege of cancellation therein contained. He is, as we held in the *Sargent Land Co. Case,* in no legal sense a purchaser of ore in place.

While *Stratton's Independence* v. *Howbert* arose under the 1909 Act, "income" has the same meaning in the Revenue Acts passed since the adoption of the Sixteenth Amendment. *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, 519; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, 335.

When the capital gains provisions first appeared in the Revenue Act of 1921 (c. 136, 42 Stat. 227), it was then regarded as settled law that mining leases did not convey title to the ore in place. See *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 371,[6] and *Ewert* v. *Robinson*, 289 Fed. 740, 747[7] (C. C. A. 8th).

It was also then settled in several of the oil-producing States that, although the proprietor of the surface could bore wells for the purpose of extracting gas and oil, he had no title whatever to them as owner until the gas and oil were actually reduced to possession.[8] At the same time it was

[6] In this case the Court said (p. 371): "It was held in both cases [*Von Baumbach* v. *Sargent Land Co.* and *United States* v. *Biwabik Mining Co.*, *supra*], as we hold here, that the leases under consideration did not convey title to the ore in place."

[7] The court here said (p. 747): "We are not dealing here with the question of whether such leases are a grant of the oil and gas or mineral within the ground. It is settled by the decisions of the Supreme Court before referred to that they are not."

[8] *Ohio Oil Co.* v. *Indiana* (No. 1) (1900), 177 U. S. 190; *The State* v. *The Ohio Oil Co.* (1898), 150 Ind. 21, 32; *Louisville Gas Co., &c.*, v. *Kentucky Heating Co.* (1909), 132 Ky. 435, 442; *Rich* v. *Doneghey* (1918), 71 Okla. 204; *Frost-Johnson Lumber Co.* v. *Salling's Heirs* (1920), 150 La. 756; *Watford Oil & Gas Co.* v. *Shipman* (1908), 233 Ill. 9; *Wagner* v. *Mallory* (1902), 169 N. Y. 501, 505; *Kelley* v. *The Ohio Oil Co.* (1897), 57 Ohio 317, 328. The question had not been definitely determined in the States of Tennessee, Kansas, Arkansas, Pennsylvania, California, and West Virginia. 1 Tex. Law Review, 163, 170–178.

practically a universal rule that the lessee under a lease which grants, leases, and lets the realty for the sole purpose of mining and operating for oil and gas, and producing and saving such products, acquired no title to such oil and gas until it was reduced to possession. Thornton, Oil and Gas (4th Edition), Sections 36, 57. This was likewise the rule in Texas (*Young* v. *Jones*, 222 S. W. 691), although a change occurred in 1923 by the decision of the Supreme Court of Texas in *Stephens County* v. *Oil & Gas Co.*, 113 Tex. 160.*

The section of the statute here involved does not indicate any intent to depart from this well-established rule. On the contrary, applying well-settled principles of construction, Congress is presumed to have legislated with the settled principles applicable to mineral leases in mind (*United States* v. *Merriam*, 263 U. S. 179, 187), and must be presumed to have used the term "sale" in its usual, ordinary, and every-day meaning (*Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 561). It is not to be presumed that Congress used the word in a sense not applicable to oil and mining leases under established law and usage recognized and declared by the decisions of the courts. Since a lease like the

* *Texas Co.* v. *Daugherty*, 107 Tex. 226, 234, decided in 1915, was generally understood as resting upon the form of the "lease" in that case, which was in terms a conveyance of the oil and gas in place. 18 Mich. Law Review, 757. *Jones* v. *Murphy* (1923), 253 S. W. 634, did not apply the rule of *Texas Co.* v. *Daugherty*.

one involved in the case at bar was understood at the time of the enactment of the law as a lease and not as a conveyance, Congress could not have intended that such a lease should be comprehended within the meaning of the term "sale."

In *Burkett* v. *Commissioner, supra,* dealing with the same question here involved under the similar provisions of the Revenue Act of 1921, the court said (p. 668):

> Whether this instrument [an oil and gas lease in Arkansas] can be described by any defined legal terms—such as lease, license, etc.—it is certain that it is only a limited grant of a right in respect to land and for a limited period of time by one having the fee and possession. Such can not be denominated a sale in the ordinary sense of that word, and there is no reason to construe section 206 as using "sale" in any other sense. The wording and the legislative history of section 206 are clear that it was intended to apply to "sales" in the sense of *conveyance of title to property,* not the *creation of privileges or estates or rights in property for a limited period of time.*

The purpose of Congress in enacting the provisions as to gains arising from the sale of capital assets indicates that the construction for which we contend is correct. Prior to 1921 gains and profits representing the increased value of property were taxed as a lump sum in the year in which the property was sold and the gain realized. Thus,

although this property represented the realization of a gradual appreciation of value extending over several years, the effect of the statute was to concentrate the gain and the tax in a single year. The profits often reached the upper surtax brackets and became subject to high rates of taxation. Consequently, the specter of the tax had the effect of inducing the owners of such property to withhold it from sale. The capital-gains provisions were adopted to relieve this situation. See *Alexander* v. *King,* 46 F. (2d) 235 (C. C. A. 10th), certiorari denied, 283 U. S. 845.[10]

The Revenue Act of 1924 continued the provision of the 1921 Act with respect to the tax upon the sale of capital assets, but, although some modifications were made,[11] there is no indication in the legislative history of an intent to bring oil and gas leases within its provisions.

The statute does not define the term "sale"; "capital assets" is defined generally, with exceptions not here pertinent, as property held by the taxpayer for more than two years. (See Section 208 (a) (8), *supra,* p. 3.) But definition is not necessary in order to determine a question of classification where the purpose of Congress is reasonably clear. *Bowers* v. *Lawyers Mortgage Co.*, 285

[10] See H. R. 350, 67th Congress, 1st Session, pp. 10–11.

[11] H. R. 179, 68th Cong., 1st Sess., pp. 19–20; S. R. 398, 68th Cong., 1st Sess., pp. 21–22; Conference Report No. 844, to accompany H. R. 6715, 68th Cong., 1st Sess., p. 15.

U. S. 182, 187. There can be no doubt that the sole purpose of Congress was to encourage the "sale" of property which was being held off the market on account of the tax situation.

The term "sale of capital assets" aptly describes the transfer of property whereby the owner parts with his entire interest for a consideration. The term does not describe a lease under which the lessor retains an interest in the land. The owner of oil lands needed no encouragement from the statute to lease his lands, for there could be no capital gain realized from the enhanced value of the property subject to tax. The tax fell only upon the income in the form of a bonus and royalties when received under the lease. The owner was deterred by the existing statutes (prior to the Revenue Act of 1921) from selling his land and thus realizing a capital gain, not from leasing his lands and receiving income in the form of rent or royalties. In view of the purpose of Congress to encourage "sales" resulting in the realization of capital gains, the statute should not be construed to cover transactions not within its purpose or within its meaning under the law at the time of its enactment.

It is a familiar rule of statutory construction that the terms used by Congress must be read in the light of, and in an endeavor to effectuate, the objects and purposes for which the statute was enacted, and that to this end the condition of affairs which led to the legislation may be considered.

American Tobacco Co. v. *Werckmeister,* 207 U. S. 284, 293. This principle of construction is not impaired by the rule that doubts in taxing statutes are to be resolved against the Government. The question here is not whether the gain from the transaction is embraced within the taxing statute; it is whether respondent is entitled to a more favorable rate than if the transaction were treated as Congress must have intended it to be in view of the considerations stated above. Thus, the situation is analogous to that where an exemption from taxation is claimed. In such cases the rule requires that the taxpayer be held liable for the tax unless clearly shown to be within the more favored class. *Bowers* v. *Lawyers Mortgage Co., supra.* Moreover, as was said in *Baltimore Talking Board Co.* v. *Miles,* 280 Fed. 658 (C. C. A. 4th), certiorari denied, 259 U. S. 587, before a doubtful statute may be given a construction favorable to the taxpayer (p. 661) "the doubt as to the meaning of the statute must be one which remains after all recognized rules for ascertaining its meaning have been tried." We believe that in holding that the construction of this statute was controlled by State decisions the court below disregarded the principles of construction to which we have referred in this part of the argument, and also certain other established principles which we discuss under the succeeding point.

III

THE STATUTE DOES NOT MAKE ITS APPLICATION DEPENDENT UPON STATE RULES AS TO THE EFFECT OF OIL LEASES BETWEEN THE PARTIES THERETO, AND THEREFORE SUCH STATE RULES MUST BE DISREGARDED IN APPLYING THE STATUTE

Until the decision of the court below in *Ferguson* v. *Commissioner, supra,* 45 F. (2d) 573, the decision of this Court in *Von Baumbach* v. *Sargent Land Co., supra,* 242 U. S. 503, was generally accepted as decisive that the State law defining the effect of a mining lease need not be followed in determining whether the consideration received under such lease constituted income or proceeds from the sale of capital assets under the Federal revenue laws. *Rosenberger* v. *McCaughn,* 25 F. (2d) 699 (C. C. A. 3d), certiorari denied, 278 U. S. 604; *Bankers Pocahontas Coal Co.* v. *Commissioner,* 55 F. (2d) 626 (C. C. A. 4th), now pending in this Court on petition for a writ of certiorari, No. 104, October Term, 1932; *Hirschi* v. *United States, supra,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576. See also *Jamison Coal & Coke Co.* v. *Commissioner,* 24 B. T. A. 554, 570.

In *Von Baumbach* v. *Sargent Land Co., supra,* the Government contended, in part, that the established law of the State with respect to the character of a mining lease should be followed.[12] But this Court said (pp. 518–519):

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[12] The State law did not treat such leases as sales. The Circuit Court of Appeals had applied the Pennsylvania rule that such leases constituted sales. Its decision was reversed. (242 U. S. 517.)

> Ordinarily, and as between private parties, there is no question of the duty of the federal court to follow these decisions of the Minnesota Supreme Court, as a rule of real property long established by state decisions. *Kuhn* v. *Fairmont Coal Company,* 215 U. S. 349, 360. Whether in considering this federal statute we should be constrained to follow the established law of the State, as is contended by the Government, we do not need to determine. The decisive question in this case is whether the payments made as so-called royalties amount to income so as to bring such payments within the scope of the Corporation Tax Act of 1909. The prior decisions of this court in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, and *Stanton* v. *Baltic Mining Company,* 240 U. S. 103, in which the *Stratton Case* was followed and approved, are decisive of this question.

In *Rosenberger* v. *McCaughn, supra,* which arose under the law of Pennsylvania, where a lease of coal lands is treated as a sale of coal in place, the court said (p. 701):

> Wholly aside from the construction which the Minnesota courts had placed upon instruments of that kind and solely because of the nature of the payments themselves, the Supreme Court, as we read its opinion [in *Von Baumbach* v. *Sargent Land Co.*] held that the instrument there in question did not effect a sale of the property * * *.

In *Bankers Pocohontas Co.* v. *Commissioner, supra,* which arose under the law of West Virginia, where the local rule was not clearly established but was assumed to be similar to the Pennsylvania rule, the court, in following the *Rosenberger* case, said that in that case (p. 629)—

> it was pointed out that in *Von Baumbach* v. *Sargent Land Company, supra,* the Supreme Court had reached the conclusion that royalties from mines constituted taxable income wholly aside from the construction placed by the Minnesota courts upon mining leases. The Supreme Court declined to review this interpretation of its decision when it denied certiorari.

In *Hirschi* v. *United States, supra,* which arose under the law of Texas, and presented the identical question involved in the instant case, the Court of Claims, in reliance upon the rule in the *Von Baumbach case* held that a cash bonus paid to a lessor of Texas oil lands was not "a capital gain" but "ordinary income."

Even if the decisions which have treated the conclusion of this Court in the *Von Baumbach case* as deciding that local rules as to the nature of mineral leases do not control in the construction and application of the Federal Revenue Acts are laid aside and the question is to be considered as still open, we believe that there is no basis for treating the peculiar rules applied to oil leases by the Texas courts as requiring a special and unusual construc-

tion of the statute when applied to the consideration paid therefor. If the income from an oil and gas lease is to be classified as capital gain when the transaction takes place in Texas but as ordinary income when the transaction occurs in any other State, it is at once apparent that Texas taxpayers will be favored in a way not contemplated by Congress. It is reasonable to suppose that Congress intended the statute to be uniformly applied, since the desirability of the uniform application of Federal statutes is generally recognized. *Calhoun Gold M. Co.* v. *Ajax Gold M. Co.*, 182 U. S. 499, 505; *United States* v. *Childs*, 266 U. S. 304, 309; *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110; *Weiss* v. *Wiener*, 279 U. S. 333; *Boston & Maine R. R.* v. *United States*, 265 Fed. 578 (C. C. A. 1st), certiorari denied, 255 U. S. 577; *Eagan* v. *Commissioner*, 43 F. (2d) 881, 883 (C. C. A. 5th. Especially is this true where the rights involved arise under the laws or Constitution of the United States. Under such circumstances it is well settled that the Federal courts are not bound by local law. *Crescent Live Stock Co.* v. *Butchers' Union*, 120 U. S. 141, 159; *Guffey* v. *Smith*, 237 U. S. 101, 114. See also *Black & White Taxicab Co.* v. *Brown & Yellow Taxicab Co.*, 276 U. S. 518. This rule has often been applied in tax cases.[13]

[13] *Fidelity-Philadelphia Trust Co.* v. *Commissioner*, 47 F. (2d) 36, 38 (C. C. A. 3d); *First Nat. Bank in Dallas* v. *Commissioner*, 45 F. (2d) 509 (C. C. A. 5th), certiorari denied, 283 U. S. 845; *Osburn California Corp.* v. *Welch*, 39 F. (2d) 41 (C. C. A. 9th), certiorari denied, 282 U. S.

From an examination of the decisions of this Court we take it to be well settled that the interpretation of a Federal tax statute is quite beyond the reach of local rules unless it is so drawn as to make its application dependent on peculiar incidents and characteristics of property which are necessarily determined by State law. If the application of the Federal statute is made dependent upon such conditions, either expressly or by implication, then necessarily the Federal courts in applying it must look to the local rule of the State to determine those characteristics. *Rosenberger* v. *McCaughn,* 25 F. (2d) 669 (C. C. A. 3d), certiorari denied, 278 U. S. 604. Such was the situation in *Crooks* v. *Harrelson,* 282 U. S. 55; *Poe* v. *Seaborn,* 282 U. S. 101; *United States* v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55; and *Tyler* v. *United States,* 281 U. S. 497.

In *Crooks* v. *Harrelson, supra,* where a Federal statute imposed a tax upon the transfer of the net estate of a decedent "To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of

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850; *California Iron Yards Co.* v. *Commissioner,* 47 F. (2d) 514, 516 (C. C. A. 9th); *Aldridge* v. *United States,* 64 C. Cls. 424; *White* v. *Hornblower,* 27 F. (2d) 777 (C. C. A. 1st); *Hart* v. *Commissioner,* 54 F. (2d) 848 (C. C. A. 1st). Cf. *St. Louis Union Trust Co.* v. *Burnet* (C. C. A. 8th), decided May 18, 1932, 323 C. C. H. 8817, 8820.

This rule is also recognized by the Texas courts. *Staley* v. *Vaughn,* 50 S. W. (2d) 907 (Tex. Civ. App.).

its administration and is subject to distribution as part of his estate," only the local law could determine whether the property in question was subject to the payment of charges against the estate and the expenses of its administration, and resort was accordingly had to the local law because the Federal statute was so drawn as to make it necessary.

In *Poe* v. *Seaborn, supra,* and the other community property cases relied upon by the court below, the statute imposed a tax "upon the net income of every individual." This Court held that the word "of" denoted ownership, and since the statute furnished no other standard of determining whether income belonged to an individual, resort was necessarily had to the State law to determine whether the wife also had an ownership in the income there involved. The same problem was presented in *United States* v. *Robbins,* 269 U. S. 315, and *United States* v. *Malcolm,* 282 U. S. 792.

In *United States* v. *Cambridge Loan & Bldg. Co., supra,* the exemption in the Revenue Acts of "domestic building and loan associations" was held to require reference to the local law, and this Court said (p. 59):

> The statutes speak of "domestic" associations, that is, associations sanctioned by the several States. They must be taken to accept, with the qualifications expressly stated, what the States are content to recognize, unless there is a gross misuse of the name.

Tyler v. *United States, supra,* is similarly distinguishable. In *Bankers Pocahontas Coal Co.* v. *Commissioner, supra,* the court said (p. 630):

> Reference is made to *Tyler, Adm'r,* v. *United States,* 281 U. S. 497; *Crooks, Col.,* v. *Harrelson,* 282 U. S. 55; and *Poe, Collector,* v. *Seaborn,* 282 U. S. 101; but it is obvious that each of these decisions turned upon the fundamental question whether the property sought to be taxed came within the purview of the taxing statutes. When it was clear that such was the case, the federal statute was given effect, as in *Tyler* v. *United States,* 281 U. S. 497 * * *.

The court below, however, seemed to think that it was required to follow the State law in the instant case because of this Court's decision in *Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279. It is submitted, however, that that case is distinguishable. There the income was that of a lessee, derived from the sale of oil and gas produced under leases of public lands executed under the laws of the State of Texas. Under the Constitution of the State of Texas such public lands could only be disposed of by sale. (See 283 U. S. at p. 281.) Immunity from the tax was claimed on the ground that the income was derived from an instrumentality of the State. On the other hand, the Government contended in part that since under Texas law, as between the State and lessee, the lessee was a purchaser and the lease constituted a sale, the

tax did not fall on the State or an instrumentality of the State but upon a private enterprise. It became necessary, therefore, to determine what was the actual fact as to the ownership of the property which produced the income.[14] If it was in fact the property of the State it was constitutionally immune from the tax. If it was in fact the property of the lessee there was no immunity. As was said in *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, 399, the reason for resort to State law in the *Group No. 1 Oil Corp. case* was because the "status of the title was matter for determination under the laws of the State as construed and applied by her courts."[15] In those cases the decision depended

[14] In this respect the *Group No. 1 Oil Corp. case* is like *Poe* v. *Seaborn*, *supra*.

[15] In the Government's brief in *Group No. 1 Oil Corp.* v. *Bass*, *supra*, the reasons for applying local law to that case, while it would be inapplicable to a case like *Hirschi* v. *United States*, *supra* (which is precisely like the present case), are stated as follows:

"* * * We are aware of the rule that in applying a Federal taxing statute this Court is not bound by the construction of a local court but is free to make its own interpretation of the nature of any instrument under consideration. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 518–519; *Burk-Waggoner Assn.* v. *Hopkins*, 269 U. S. 110, 114; *B. & W. Taxi. Co.* v. *B. & Y. Taxi. Co.*, 276 U. S. 518, 530. This principle is applicable in situations analogous to those in *Hirschi* v. *United States*, 67 C. Cls. 637, certiorari denied, 280 U. S. 576, and *Burkett* v. *Commissioner*, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565, where the controversy turned upon whether or not the taxpayers' incomes were within the terms of the Federal taxing statute there in question. On the other hand, however,

on the relationship that the particular State bore to the land from which the income was derived. So far as the United States was concerned, that was a question between "private parties" in the decision of which local law controls. Cf. *Von Baumbach* v. *Sargent Land Co., supra.* If under the local law the State had sold its property to others, it was held that the effect of a Federal tax upon the income of the purchaser could be disregarded, while the contrary was held if the State retained a proprietary interest.

There is no question here of determining the relation between the State of Texas and a lessee with which it contracted. This case is concerned with a lease made between private parties, and the question is not whether a Federal tax imposes an unconstitutional burden upon the State, but merely whether the income produced by the lease is to be put in one class or another. The classification is made by a Federal statute. The power of Congress to make a classification satisfactory to itself without regard to State law must be conceded, and

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where the point in controversy relates to property rights as between two contracting parties, the rule of the local court will be followed in the Federal courts. *Von Baumbach* v. *Sargent Land Co., supra; Waggoner Estate* v. *Wichita County*, 273 U. S. 113, 117. Accordingly, so far as the relationship between petitioner and its lessor is concerned, the interpretation of the Texas court is deemed to be controlling."

we are concerned only with the intention and purpose of the statute.

Unlike the statutes involved in the cases where resort was had to the local law, Congress has not indicated any purpose that the classification of "ordinary income" and "capital gains" should depend upon local law. General terms are used which are well understood. Reference to local law is not necessary to enable the taxing authorities or the courts to determine where the tax falls, for the criteria necessary to decision are all established by the statute when read in the light of the decisions of this Court cited *supra*, pp. 12–14. Treatment of the bonus received by respondent as "ordinary income" instead of "capital gain" leads to no conflict between Federal law and State law. On the contrary, such conclusion is predicated upon a Federal statute which, in the absence of any indication of a purpose that the incidence of the tax should vary with artificial variations of the local laws of the various States, must be held to contain its own criteria based upon familiar rules established by this Court. Accordingly, we think that the local rule must be disregarded as was done in *Weiss* v. *Wiener*, 279 U. S. 333; *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110.

In *Weiss* v. *Wiener, supra*, a Federal statute granting a deduction of "a reasonable allowance for the exhaustion, wear and tear of the property used in the trade or business" was involved. Wiener was a lessee and sought an allowance for de-

preciation of property held under a ninety-nine-year lease, renewable forever, which under the local law was treated as in many respects like a conveyance of the fee. The deduction was denied, and this Court refused to follow the local law, saying (p. 337):

> It does not matter that in Ohio, where the properties lie, these long leases are treated as in many respects like conveyances of the fee. The Act of Congress has its own criteria, irrespective of local law, that look to certain rather severe tests of liability and exemption and that do not allow the deductions demanded whatever the lessees [leases] may be called.

In *Burk-Waggoner Oil Assn.* v. *Hopkins, supra,* it was sought to tax as a corporation a joint-stock association which, under the law of Texas, was not recognized as a legal entity but was deemed to be a partnership. The Federal statute did not define the term "joint-stock association" but simply classified such an organization as a corporation. This Court said (p. 114):

> It is true that Congress can not convert into a corporation an organization which by the law of its State is deemed to be a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated. The power of Congress so to tax associations is not affected by the fact

> that, under the law of a particular State, the association can not hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed.

In the decision in the *Ferguson case, supra,* 45 F. (2d) 573, 575, reference is made to the collection of stamp taxes upon oil leases in the State of Texas under the provisions of the Revenue Act of 1921 (Schedule A, 6, Title XI) and the corresponding provisions of the Revenue Act of 1924 (Schedule A, 5, Title VIII, U. S. C., Title 26, Sec. 901). It is said to be inconsistent to classify these leases as "conveyances * * * whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers * * *," and at the same time to deny that such leases are sales of capital assets. Article 29 of Regulations 55 provides as follows:

> What constitutes "lands, tenements, or other realty" is determinable by the law of the State in which the property is situated. Standing timber is ordinarily held to be real estate, and where so held the deed transferring it is subject to the tax.

Since oil and gas leases are treated by the Texas decisions as conveyances of real estate, the stamp tax was properly collected unless the provision of the regulations that the local law controls is erroneous. The regulations with respect to capital gains do not purport to make the local law applicable, and whether Regulations 55 properly construes the stamp-tax statute is not in question here. Putting the Texas decisions aside, it is still true that even though an oil and gas lease does not amount to a conveyance of the oil and gas in the ground, it does amount to a conveyance of an interest in the land. *Ewert* v. *Robinson,* 289 Fed. 740, 750 (C. C. A. 8th). This Court is not now called upon to decide whether the stamp tax was properly collected, and if the Treasury Department has been inconsistent and the distinction which has been made is unsound, that should not prevent the application of the correct rule in the present case.

CONCLUSION

It is respectfully submitted that the decision of the court below should be reversed.

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APR 8

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

HENRY HARMEL.

Reply to Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 824.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

HENRY HARMEL.

Reply to Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

QUESTION PRESENTED.

The question presented is whether a cash consideration received by the owner of lands situated in Texas for the execution of an instrument commonly known as an "oil and gas lease," which, under the law of Texas conveys title to the oil and gas in place, is taxable as the "gain derived from the sale or exchange of capital assets" under Section 208 of the Revenue Act of 1924. "Capital assets" are defined in the statute as "property held by the taxpayer for more than two years."

It is admitted that the cash received is taxable income. If it is income from the sale of capital assets it is taxable at the flat rate of 12½ per cent provided in Section 208.

No question is presented regarding the taxing of any royalties which may have been received under the instrument.

STATUTES.

REVENUE ACT OF 1924:

"Sec. 208. (a) For the purpose of this title—

"(1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921; * * *

"(8) The term 'capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the tax-payer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

"(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

"A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain."

STATEMENT.

The Respondent, Henry Harmel, resides at Megargel, Texas. In 1924 he was, and had been for many years, the owner in fee simple of certain lands located in

Archer County, Texas. In 1924 he executed two oil and gas leases (R. 25-34) covering the land. In consideration therefor he received $57,000.00 in cash.

The Respondent, in his income tax return for 1924, treated this entire sum as capital gain under Section 208 of the Revenue Act of 1924. The Commissioner of Internal Revenue held it was not capital gain and was taxable at ordinary rates. The Board of Tax Appeals affirmed the Commissioner (R. 14-18), 19 B. T. A. 376, and the Circuit Court of Appeals for the Fifth Circuit reversed the Board (R. 35-36).

One of the instruments in question provides that the Respondent, styled Lessor, "for and in consideration of Twenty Thousand and no/100 Dollars, and other considerations hereinafter set forth cash in hand paid, the receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of the lessee to be paid, kept and performed, has granted, demised, leased and let, and by these presents does grant, lease and let, etc." (Record 25-26)

The other considerations referred to are stated in the instrument to be: "The other consideration above mentioned is the sum of $20,000.00 which shall be paid to the lessor hereof out of one-half of seven-eighths of the first oil produced on said land." (Record 29)

The other instrument provides "That the said lessor, for and in consideration of Forty-four Thousand and no/100 Dollars cash in hand paid, and the consideration hereinafter named, receipt of which is hereby acknowledged and of the covenants and agreements hereinafter contained on the part of the lessee to be paid, kept and performed, has granted, conveyed, demised, leased and let, and by these presents do grant, convey, demise, lease and let, etc." (Record 30)

The further consideration referred to in this instance was $44,000.00 to be paid the lessor "out of one-half of seven-eighths of the first oil produced from said land

and a vendor's lien is retained against said leasehold estate and the oil produced therefrom until the full sum of Forty-four Thousand Dollars is paid." (Record 33)

Each instrument provides for royalties as follows:

(a) one-eighth of all oil produced;
(b) One-eighth of the value at the well of gas produced from gas wells; and
(c) One-eighth of the value of gas produced from oil wells and used off the premises,

(Record 26, 27, 31)

ARGUMENT.

1.

The petitioner predicates his application for a writ in this case upon the conflict of the decision below with the decision of the Court of Claims in *Hirschi v. United States,* 67 Ct. Cls. 637 (decided May 6, 1929; certiorari denied 280 U. S. 576). Since the Hirschi decision this Court has settled the law which controls this case, as will be shown hereafter. It is, therefore, submitted that this conflict does not require the granting of the writ.

In this case the Court below held that the consideration received by the Respondent for executing the instruments set out in the statement was taxable at the flat rate of 12½ per cent as a "capital gain" under the Statute (Sec. 208, Revenue Act of 1924) which defines "capital gain" as "taxable gain from the sale or exchange of capital assets" and then defines "capital assets" as "property held by the taxpayer for more than two years". The Court reached this conclusion because of the settled law of Texas that such an instrument conveyed to the so-called lessee title to the oil and gas in place and was, therefore, a "sale" within the terms of the Statute. This opinion merely followed and re-affirmed the conclusions reached by the same Court in 1930 in *Ferguson v.*

Commissioner, 45 F. (2d) 573. The Government did not ask for a rehearing nor for certiorari in the Ferguson case.

In the Hirschi case, decided in 1929, the Court of Claims held that such gains were not capital gains, but were to be taxed at ordinary rates, refusing to give effect to the Texas law and treating the question as foreclosed by the decisions of this Court holding that the income from mining operations was taxable under the 1909 Corporation Excise Tax Law and the Revenue Act of 1913, without deduction for the value of the ore in place (*Stratton's Independence v. Howbert* 231 U. S. 399; *Stanton v. Baltic Mining Co.,* 240 U. S. 103; *VonBaumbach v. Sargent Land Co.* 242 U. S. 503; *U. S. v. Biwabik Mining Co.,* 247 U. S. 116).

That the local law is to be applied to determine whether or not a sale has taken place (in order to determine the incidence of a Federal tax where Congress has not put into the Act criteria for determining the question) has been quite recently decided by this Court in an almost identical situation (*Group No. 1, Oil Corporation v. Bass,* 283 U. S. 279). In that case this Court, in determining whether or not the income from the oil leases there involved was taxable under Federal Revenue Laws, held that the oil leases there involved were "present sales to the lessees, upon the execution of the leases, of the oil and gas in place" (page 281), upon the authority of *Theisen v. Robison,* 117 Texas 489. This, the Court said, was the settled law of Texas as announced in *Texas Company v. Daugherty,* 107 Texas 226, and *Stephens County v. Oil & Gas Company,* 113 Texas 160. Therefore this Court held that the lessees were taxable upon the income derived from the oil-producing operations conducted on these lands even though the lands in question were University lands belonging to the State of Texas and, but for this rule, the income in question might have been exempt from taxation.

This express recognition that State rules of property must be looked to in determining the incidence of a Federal tax where, as here, the ownership of real estate is the controlling question and Congress has not seen fit to limit the general terms used, carries out the principle applied by this Court in the Community Property cases (*Poe v Seaborn*, 282 U. S. 101, and other cases decided the same day; *U. S. v. Malcolm*, 282 U. S. 792; compare *Robbins v. U. S.*, 269 U. S. 315).

These very recent decisions by this Court so plainly authorize and compel the conclusions reached by the Court below, that it would appear unnecessary for this Court to grant the writ prayed for in order to resolve the conflict with the Hirschi case decided before the decisions above referred to.

2.

It is further submitted that a conflict between the decision of a Circuit Court of Appeals and the Court of Claims is not a reason for granting a writ of certiorari within Rule 38, paragraph 5 (b) of this Court.

3.

Stratton's Independence v. Howbert, 231 U. S. 399; *Stanton v. Baltic Mining Co.*, 240 U. S. 103; *VonBaumbach v. Sargent Land Co.*, 242 U. S. 503; and *U. S. v. Biwabik Mining Co.*, 247 U. S. 116; are not in conflict with the decision in this case. As heretofore stated, they arose under the Corporation Excise Tax Law of 1909 and the Revenue Act of 1913. In none of these acts were capital gains taxed differently from recurring gains. The capital gains feature of the law was first introduced into the Federal taxation in the Revenue Act of 1921, long after these cases were decided.

All dealt with the income from mining operations and not with transfers of mining property. The basic ques-

tions involved were entirely different. In some of the cases the question was whether the Excise Tax Law applied to mining companies. In others the question was whether the proceeds of ore mined constituted income and whether such corporations were entitled to deduct from the proceeds so received the value of the ore in place in arriving at the income to be taxed. In the *Stanton* case, under the Revenue Act of 1913, the question was whether the failure to allow more than five per cent of the value of the product for depletion rendered the tax a direct one on property and unconstitutional. In one case (*Stratton's Independence*) the mine was owned in fee. *Sargent Land Co.* was a lessor, and that case dealt with royalties on ore extracted by the lessee. The *Biwabik Mining Company* was a lessee and the precise question was whether, under the 1909 Act, it had the right to deduct from gross income the value in place,—not cost, of the ore mined.

Plainly these decisions have no bearing upon the question decided by the Court below, and the Lower Court's decision is not in conflict with them.

4.

The various decisions of other Circuit Courts and the Court of Appeals of the District of Columbia cited by the petitioner do not conflict. The majority of these, instead of dealing with the question at issue here, deal with the proper method of taxing the royalties received from oil-producing operations. In fact, no showing was made in this case as to whether any oil was ever produced under the leases in question and the leases themselves show that no royalties were to be paid except upon and as oil and/or gas were actually produced. This is applicable to the following cases cited by the Petitioner: *Murphy v. Commissioner* (App. D. C.), decided Feb. 20, 1930, and reported at 2 Prentice-Hall 1930, p. 1963 affirming *J. E.*

Murphy v. Commissioner, 9 B. T. A. 610; *Reynolds v. Commissioner* (App. D. C.), decided Feb. 20, 1930, without opinion and affirming *J. D. Reynolds v. Commissioner,* 10 B. T. A. 651; *Alexander v. King* (C. C. A. 10th), 46 F. (2d) 233 (certiorari denied 283 U. S. 845).

While *Burkett v. Commissioner,* 31 F. (2d) 667, and *Berg v. Commissioner,* 33 F. (2nd) 641, decided that the consideration received for the execution of the oil leases there involved were not to be taxed as capital gain, neither conflicts with the decision below in this case because both involved land in Arkansas and the courts which decided those cases were not called upon to determine the basic question here involved, that is,—What is conveyed by such instruments in Texas?

5.

Rosenberger v. McCaughn (C. C. A. 3d), 25 F. (2nd) 699, and *Bankers Pocahontas Coal Co. v. Commissioner* (C. C. A. 4th), 55 Fed. (2d) 626, dealt with the proper method of taxing one who, prior to March 1, 1913, acquired the right to receive royalties from a coal mine upon payments received subsequent to March 1, 1913. The question of taxing the proceeds from the transfer of mining property is not involved. In each case it is clear that the same result would have been reached had the original leases (made before March 1, 1913) been considered sales of the ore in place and the royalty payments the consideration therefor, for certainly there is the same element of profit in the deferred consideration when collected.

6.

Burk-Waggoner Oil Association v. Hopkins, 269 U. S. 110, presented an entirely different question. There it was held that the fact that a joint stock association was, under the law of Texas, a partnership, did not deprive

Congress of the power to classify it as a corporation for the purpose of imposing the tax and did not render unconstitutional the tax upon its income. No question is presented in the case at bar as to Congressional power. Admittedly Congress could refuse to extend the benefits of the capital gains sections to transactions like those involved here, just as it refused to extend them to property not owned for two years, or to "property held primarily for sale in the course of his trade or business", (Sec. 208(a)(8), Revenue Act of 1924). But until Congress sees fit to limit the meaning of "sale or exchange" or "capital assets", the question presented in the *Burk-Waggoner* case will not arise.

In *Weiss v. Weiner,* 279 U. S. 333, it was expressly stated that the Act of Congress had provided its own criteria for determining under what circumstances depreciation deductions would be allowed and, therefore, the fact that, under the law of Ohio, long-term leases upon real estate were treated in many respects like conveyances of the fee was unimportant in determining to whom and under what circumstances the statutory depreciation deductions were to be allowed. The decision of the Court below does not conflict with decisions like these.

7.

In *Work vs. Mosier,* 261 U. S. 352, the Court was dealing neither with a problem of taxation nor with any local law relating to oil and gas leases. Instead, the Court was construing an ambiguous statute relating to the disposition of tribal lands and funds of the Osage Indians, and resolved the ambiguity in a way thought more nearly to carry out the congressional intention.

Congress, by Statute passed in 1906, had provided for the division of the lands and funds of the Osage Indians in Oklahoma Territory among the members of that Tribe, the lands to be divided by selection. The same Act forbade the sale of oil and other minerals in the lands and

reserved these minerals, and the uses and benefits arising therefrom, for the Tribe as a whole for a period of twenty-five years, the Act providing that for that period the royalties should be paid to the Tribe and that at the end of the twenty-five year period the oil and other minerals should become the property of the individual allottees of the land, unless otherwise provided. It was also provided that periodical distribution of the royalties received should be made to the members of the Tribe and that the amount of these royalties were to be fixed by presidential decree.

The unforeseen condition which arose, as is disclosed by the opinion of the Court, was that large sums were received as bonuses in the sale of such leases, which were made at public auction. In this situation it became necessary for the Court to determine whether, under this Statute, these bonuses should be distributed among the members of the Tribe during the twenty-five year period, or whether they should be withheld during such period and, at the end thereof, go to the individual allottee from whose land the oil was produced. It was clearly the purpose of Congress that the benefits of such minerals as might be developed under the entire land should go to the Tribe as a whole during the twenty-five year period, and not to those particular allottees who were fortunate enough to receive as their allotment a tract of land later discovered to contain minerals. Under these circumstances, the Court said (page 357):

> "But, in the unexpected event, we must decide under what head the bonus is to be treated,—whether as capital or income,—and it seems clear to us that, in view of the entire statute, it is more aptly described by the latter term."

It was only by reaching this conclusion that the intention of Congress,—that the entire Tribe, rather than indi-

vidual allottees should share in all of the benefits obtained from the minerals,—could be carried out.

We also call the Court's particular attention to the discussion of this case in *Ferguson vs. Commissioner,* 45 Fed. (2) 573, 576-7.

8.

The Board of Tax Appeals is now following the Ferguson decision in cases arising in Texas. *Waggoner v. Commissioner,* 24 B. T. A. 657; *Tippett v. Commissioner,* 25 B. T. A. 69.

CONCLUSION.

The Court below followed the very recent rulings of this Court in deciding the question presented. It would appear that there is no further room to question the soundness of that decision and that, without further action by this Court, the principles decided below in this case and the Ferguson case, will be followed. Therefore, it is unnecessary for this Court to further review this case.

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April, 1932.

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No. 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

versus

HENRY HARMEL, *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

versus

HENRY HARMEL, *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR RESPONDENT

(All *italics* throughout are ours, unless otherwise noted).

Opinions Below

This case originated in the United States Board of Tax Appeals. That Board's decision is reported in 19 B. T. A. 376. The opinion of the United States Circuit Court of Appeals for the Fifth Circuit (per Bryan, Circuit

Judge) is reported in 56 Fed. (2d) 153. Certiorari was granted April 18th, 1932, 52 Sup. Ct. 498.

Jurisdiction

The judgment of the Fifth Circuit Court of Appeals was entered Feb. 23, 1932 (R. 21). The petition for certiorari was filed March 24th, 1932, and was granted April 18, 1932. (R. 22). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented

The Respondent, in 1924, executed and delivered two oil and gas leases on lands in Texas for cash considerations, which admittedly constituted taxable income. The question presented is whether this taxable income was gain derived from the sale or exchange of capital assets, as that term is defined in Section 208 of the Revenue Act of 1924, and therefore taxable at the flat rate of 12 1-2 per centum imposed by this Section, or must this gain be classified as ordinary income, subject to the progressive normal and surtax rates imposed by Sections 210 and 211 of said Revenue Act?

Statutes Involved

Revenue Act of 1924:

"Sec. 208 (a). For the purpose of this title—(1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term 'capital loss' means deductible loss resulting from the sale or exchange of capital assets;

(3) The term 'capital deductions' means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;

(4) The term 'ordinary deductions' means the deductions allowed by section 214 other than capital losses and capital deductions;

(5) The terms 'capital net gain' means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term 'capital net loss' means the excess of the sum of the capital losses plus the capital deductions over the total amount of the capital gain;

(7) The term 'ordinary net income' means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term 'capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12 1-2 per centum of the capital net gain.

(c) In the case of any taxpayer (other than a corporation) who for any taxable year sustains a capital net loss, there shall be levied, collected, and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount minus 12 1/2 per centum of the capital net loss; but in no case shall the tax under this subdivision be less than the taxes imposed by sections 210 and 211 computed without regard to the provisions of this section.

(d) The total tax determined under subdivision (b) or (c) shall be collected and paid in the same manner, at the same time, and subject to the same provisions of law, including penalties, as other taxes under this title.

(e) In the case of the members of a partnership, of an estate or trust, or of the beneficiary of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordi-

nary net income, capital net gain, or capital net loss, shall be determined under rules and regulations, to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections 218 and 219, but at the rates and in the manner provided in subdivision (b) or (c) of this section."

Statement

Respondent, Henry Harmel, resided in Texas. In October, 1924, he had owned for many years certain lands in Archer County, Texas. (R. 8-14-17). On October 13, 1924, he executed an oil and gas lease to one E. R. Fain covering a portion of this land for a cash consideration; and, on October 21, 1924, he executed another such lease to one J. A. Gardner, for a cash consideration, covering another portion of said land (R. 14-17).

The cash considerations so received totaled $57,000.00 (R. 8). This sum was reported by the Respondent in his 1924 income tax return as "capital gain" subject to taxation at 12 1/2 per centum (R. 9). The Petitioner, upon auditing this return, held that this sum was ordinary income and, by virtue of the change, determined that Respondent was liable for an additional tax (R. 3-5). From this determination, Respondent appealed to the United States Board of Tax Appeals (R. 2), and the issue thereby presented has been brought, by the customary procedure, to this Court for determination.

The oil and gas leases in question are set out in full

in the record. (Fain lease, R. 14-17; Gardner lease, R. 17-19).

These instruments appear to be along the usual lines in use in the Texas Oil Fields. The terms of the Fain lease may be summarized as follows:

Consideration:[1] $20,000.00 cash, receipt of which was acknowledged, "the covenants and agreements" later set out, to be performed by Fain, and "other considerations" which the instrument discloses (R. 17) to be the further sum of $20,000.00 to be paid out of 1-2 of 7-8ths of the first oil produced. (R. 14).

Granting Clause: "Has granted, demised and let * * * unto the said lessee for the sole and only purpose of mining and operating for oil and gas and of laying pipe lines, power stations and structures thereon to produce, save and take care of said products." (R. 14-15).

Land Covered: Forty (40) acres. (R. 15).

Term: Three (3) years from date, and as long thereafter as oil or gas, or either, is produced from the land by lessee. (R. 15).

Lessee's Covenants and Agreements:

---

[1]A consideration of these instruments will refute the statement contained in Petitioner's brief under "Question Presented" (page 2 thereof) and reiterated in other places that these sums were paid "as advance royalties." It is entirely clear from an examination of the instruments that the cash payments were in nowise dependent upon the production of oil, and that the royalty provisions of the instrument are entirely separate and distinct from the consideration.

Royalties: 1-8th of the oil produced and saved, delivered in the pipe line, free of cost.

1-8th of the value of the gas produed from gas wells;

1-8th of the value of casinghead gas (gas from oil wells. (R. 15).

Drilling Obligations: To begin the drilling of a well within one year or pay an annual rental of $2.00 per acre per year; to resume development or delay rental payments within one year after a dry hole was completed. (R. 15-16).

Miscellaneous Covenants: To pay damages to growing crops, bury pipe lines, etc. (R. 16).

Further Terms: Warranty of title by Harmel, with subrogation clause against mortgages, taxes, etc.; express grant of the privilege of assignment by either party, etc.; grant to lessee of right to remove machinery, etc., and other standard provisions. (R. 16).

The Gardner lease (R. 17-19) follows, substantially, the terms of the Fain lease. The following variations (which, it is submitted, are without significance) will be noted:

Consideration: $44,000.00 cash, the customary covenants and agreements, and a further payment of $44,000.00, out of 1-2 of 7-8ths of the first oil produced, secured by the vendor's lien upon the estate granted. (R. 17-19).

Granting Clause: "Has granted, conveyed, demised, leased and let, etc." (R. 17).

Land Covered: Eighty (80) acres. (R. 17).

Miscellaneous Agreements: Express agreement to drill two wells, on penalty of termination, etc. (R. 19).

SUMMARY OF ARGUMENT

I.

Under the Statute (Sec. 208), Respondent is entitled to the application of the capital gain rate, if he made a "sale or exchange" of "property" held by him for more than two years. These conditions have been fulfilled because:

(a) Admittedly, the property in question had been held more than two years and the other limitations of subdivision (a) (8) of Section 208 have no application.

(b) Congress did not limit either the term "property" or the term "sale or exchange" so that the meaning of these terms is to be found in the general law. Under such law "property" is a term of very broad signification, embracing everything that has exchangeable value or goes to make up a man's wealth, every interest or estate which the law regards of sufficient value for judicial recognition; while a sale is ordinarily "a transfer of property for a fixed price in money, or its equivalent." Nothing in the Revenue Act warrants placing any limitation upon the ordinary meaning of these terms.

(c) The laws of Texas, in which State the transaction took place and the land was situated, govern in determining what interest Harmel had in the minerals in and under his land; and what interest was conveyed by the instruments in question.

(d) Under Texas law, oil and gas in place are a part of the real estate belonging to the fee owner; and the execution of the instruments in question constituted present sales to the lessees of the oil and gas in place; the estate conveyed was a determinable fee; these holdings constitute rules of property in Texas.

(e) The above holdings do not constitute mere terminology; but, under Texas law and decisions, the vital attributes which ordinarily follow such estates attach in full measure to the determinable fee granted by such an instrument. Texas rules regarding operation, conveyancing, taxation, etc., support this.

(f) Apart from Texas property rules, the interest of the land owner in oil and gas in place is everywhere recognized as a valuable property right, and the transfer of such right to an operator for a cash consideration, in addition to stipulated royalties, is a "sale or exchange" under the statute, requiring the application of the capital gain tax rate to the profit from the transaction.

(g) These conclusions are supported and required by (1) the legislative history of the capital gain section, (2) the departmental construction and interpretation of related sections of law, particularly as to the stamp tax upon leases, and the rules regarding depletion, (3) the relation of state rules of property to Federal Taxing Acts, exemplified by the *Community Property* decisions of this Court,[1] and similar cases, and (4) by the distinctions

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[1]*Poe v. Seaborn*, 282 U. S. 101; *Goodell v. Koch*, 282 U. S. 118; *Hopkins v. Bacon*, 282 U. S. 122; *Bender v. Pfaff*, 282 U. S. 127; *U. S. v. Malcolm*, 282 U. S. 792.

drawn by this Court in the *Group No. 1*[1] and *Coronado* cases,[2] recently decided.

II.

That Congress clearly understood that oil and gas "leases" constituted sales is shown by its repeated approval of the Department's holding subjecting them to stamp taxes, and the treatment of the consideration as cost for depletion purposes.

III.

The questions involved should not be beclouded with issues not in the case. It is admitted by both parties that the sum in question is taxable income—that such income was derived from the conversion of capital assets does not affect this—and, therefore, questions as to what is and what is not income, long since settled by this Court, have no bearing upon the issues here involved. Likewise, the powers of Congress in the selection of objects of taxation are not questioned. Our inquiry is as to what Congress *has* done. We do not contend that Congress could not have excluded transactions like those involved from the benefits of the Capital Gain Section had it seen fit to do so.

Hirschi v. United States was wrongly decided because the Court of Claims erroneously construed the taxpayer's position as an attempt to limit the Federal taxing power by State property rules, and failed to rec-

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[1]*Group No. 1 Oil Corporation v. Bass*, 283 U. S. 279.
[2]*Burnet v. Coronado Oil & Gas Company*, 284 U. S. 606.

ognize that Congress had, by the language used, made such State rules the test of whether a sale had taken place. Likewise, that Court wrongly held that the case was ruled by *Stratton's Independence v. Howbert; Stanton v. Baltic Mining Company; U. S. v. Biwabik Mining Company* and *Von Baumbach v. Sargent Land Company.*

These last named cases, as well as *Work v. Mosier,* have no bearing upon the question presented here.

Weiss v. Weiner; Burk-Waggoner v. Hopkins; Rosenberger v. McCaughn and *Bankers' Pocahontas Coal Company v. Burnet* are clearly distinguishable from the case at bar.

The true rules to be applied, in relating State property rules to Federal tax problems, are those announced and applied by this Court in the *Group No. 1 Oil Corporation,* the *Coronado Oil & Gas Company* cases and the *Community Property Income Tax* cases, in *Crooks v. Harrelson; U. S. v. Cambridge Loan & Building Company,* and in *Tyler v. United States.* An excellent example is *Leser v. Burnet,* 46 Fed. (2d) 756, by the Fourth Circuit.

In every case where the Statute makes the incidence of the tax depend upon the ownership of, powers over, or transfers of property, State law must be looked to to determine whether a transfer has taken place, who owns the property and what powers any one can exercise over it.

IV.

The Circuit Court of Appeals for the Fifth Circuit correctly applied these rules in deciding the same ques-

tion in *Ferguson v. Commissioner*, 45 Fed. (2d) 573, involving the identical question, and in the case at bar, and that Court's judgment should be affirmed.

ARGUMENT

Preliminary Statement

The basic question involved in this case is identical with that decided in favor of the application of the Capital Gains Section by the Fifth Circuit Court of Appeals in the case of *Ferguson v. Commissioner*, 45 Fed. (2d) 573. No further action was taken by the Government in that case, but the Court below was asked in this case to reverse its prior ruling. For this reason, the views of the Court below upon the question will be found to be much more fully stated in the Ferguson decision than in the opinion rendered in this case.

We believe it may be fairly said that the greater part of the difficulty which has apparently surrounded the question has arisen from the fact that the term 'lease' in connection with oil and gas is a misnomer, but has been so long used as to become practically a trade term.

It was early said in England:

> "What we call a mineral lease is really, when properly considered, a sale out and out of a portion of the land." *Gowan v. Christie*, 5 Moak 114, per Lord Cairns.

Certainly the effect of the language used, and not the name given the instrument, is the determining factor. See Thornton on Oil & Gas (1932), Sec. 77, p. 127.

A.

Since it is clear that Harmel owned the land in question for more than two years, that it was not held primarily for sale in the course of his trade or business, and was not of a kind properly to be included in inventory (Sec. 208 (a) (8)), our problem is simply whether Harmel, by the instruments in question, sold property.

By Sec. 208 (a) (8), a "capital asset" is "property" held by the taxpayer for more than two years, the limitation contained in subdivision (a) (8) having, as above stated, no present application. A "capital gain" is taxable gain from the "sale or exchange" of such a capital asset. If a taxpayer receives a "capital gain," subdivision (b) of Section 208 gives him the election of having such gain taxed at 12 1-2 per cent, rather than at the progressive rates provided in Sections 210 and 211.

Nowhere in the Act has Congress sought to limit the very general terms used. We have only to find the meaning of "property" and "sale or exchange" under general law and then turn to the laws of Texas, in which State the transaction took place and the land in question was located, to determine whether the interest which Harmel had in the subject matter of the transaction constituted "property" within the general definition, and, by the same standard, whether the transactions between Harmel and Fain, and Harmel and Gardner, constituted sales or exchanges.

Under the decisions of this, and all other courts, and in common parlance, "property" is a word of the broadest meaning. It embraces every right, interest or estate

which the law deems of sufficient importance to protect.[1] Regardless of the divergent views of Courts as to the exact estate which a fee owner has in the oil and gas, as well as solid minerals, in or under his land, it is everywhere admitted that his interest therein is a valuable and merchantable right, or property.[2] So, without question, the Bureau of Internal Revenue,[3] the Board of Tax

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[1] *Webster's New International Dictionary* gives, among others the following definition: "Any thing, or those things collectively, in or to which a man has a right protected by law." "In a broad sense, any valuable right or interest considered primarily as a source or element of wealth."

"Property is a term of very broad signification, embracing everything that has exchangeable value or goes to make up a man's wealth, every interest or estate which the law regards of sufficient value for judicial recognition." *Samet v. Farmers & Merchants Natl. Bank of Baltimore* (C. C. A.), 247 Fed. 669, 671.

Chief Justice Marshall in *Soulard v. United States*, 4 Peters 511, said: "The term 'property' as applied to lands, comprehends every species of title inchoate or complete. It is supposed to embrace those rights which lie in contract—those which are executory as well as those which are executed." See also *Belk v. Henry Meager et al.*, 104 U. S. 279, *Sullivan v. Iron Silver Mining Company*, 143 U. S. 431.

[2] *Forbes v. Gracey*, 94 U. S. 762, 24 L. Ed. 313, 14; *Lynch v. Alworth-Stephens Company*, 267 U. S. 364.

[3] *I. T. 2524*, Cum. Bul. IX-1, page 199, where the conveyance of an undivided interest in all of the oil, gas and other minerals under described lands was classified as a sale of capital assets. See also *G. C. M. 2367*, Cum. Bul. VI-2, p. 172, where the sale by a taxpayer, in 1922, of the right to take gravel from land was classified as the sale of capital assets.

Appeals,[1] and the Courts,[2] treat the transfer of these rights by mineral deed or royalty sale as the sale of "property" constituting a capital asset.

Likewise, the term "sale" has a well defined meaning. This Court has said that a sale is "ordinarily, a transfer of property for a fixed price in money or its equivalent." *Five Per Cent Cases*, 110 U. S. 421. *Black* says that it is "a contract between two parties * * * by which the former, in consideration of the payment or promise of payment of a certain price in money, transfers to the latter the title and possession of an object of property." This Court has said again that "At all times, it means a contract between parties to give and to pass rights of property for money."[3]

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[1]*Murphy*, 9 B. T. A. 610, acquiesced in by the Bureau of Internal Revenue, Cum. Bul. VII-2, p. 28, affirmed without opinion by the Court of Appeals of the District of Columbia, February 10, 1930. *Reynolds v. Commissioner*, 10 B. T. A. 651.

[2]Both the *Reynolds* and *Murphy* cases, cited in the preceding note, were affirmed without opinion on the authority of *Berg v. Commissioner*, 33 Fed. (2d) 641, by the Court of Appeals of the District of Columbia.

[3]*Williamson v. Berry*, 8 Howard 495, 544. See also definitions collected in *Ferguson v. Commissioner*, 45 Fed. (2d) 573, 4, 5.

There is nothing, either in the accepted definitions of "sale," or in the Taxing Acts, which require the seller to part "with his entire interest" in the subject matter of the sale in order to comply with the Statute (see p. 8, Petitioner's brief). Certainly the Statute applies as plainly and aptly to the sale of an undivided interest or a mineral interest as it does to the entire fee simple title to a property. Nor are we able to understand why the "spectre of the tax," referred to by the

Congress could have, by definition or limitation, enlarged or restricted this meaning in the Revenue Act, and this would have bound the Courts in construing it. But no other authority, State or Federal, could do so. In the absence of definition or restriction, it remains only to apply to the fact situation, the well understood meaning of the term. Certainly the Respondent does not contend that any different definition of "property" or "sale" by the Courts of Texas—assuming, as is not the case, that the terms are differently defined by Texas Courts—would limit to the slightest extent the right of the Federal executive and judicial authorities to place upon the terms, when contained in a Federal taxing act, their general, well understood, meaning.

But just as certainly as Federal authority is exclusive and paramount in that field, so is the authority of Texas to fix and determine, by legislative act and judicial pronouncement, the interest of a land owner in the minerals under his land and the effect of a written instrument relating thereto, paramount and exclusive. No Court[1] has

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Petitioner (p. 17, Petitioner's brief) is not as much a deterrent to the owner of oil property as it is to the owner of any other kind of property. The deterrent was the high progressive surtax by which 50 per cent, or more, of receipts might be taken, and not the fact that the receipts might come from any particular source.

[1]For example, see *Hines Yellow Pines Trustees v. Martin*, 268 U. S. 458, 464, where this Court said: "But where the rule is one affecting title to real estate within the State, and has been repeatedly determined by decisions of state Courts, so it is established as the law of the state, there has been no departure from the rule that the Federal courts will follow the decisions of the state

more readily and frequently recognized this principle than has this. The general rulings are innumerable and to discuss them is surely unnecessary.

When we turn to the particular field of Federal taxation, and the effect to be given to State rules of property, when general language is used in a Federal taxing act, we find the same recognition of their effect that is here urged.

In the recent *Community Property Income Tax* cases,[1] this Court, in applying the law which taxed the net income *"of"* every individual, turned to the community property laws of Washington, Louisiana, Texas and Arizona, to determine whether the wife owned a portion of community income and, finding that she did, held that she, and not her husband, was to be taxed upon that part which State law said she owned. And shortly thereafter California, where the wife had theretofore been denied the right of reporting a share of the community income because she did not have under State law actual ownership,[2] presented for this Court's consideration the changes in the wife's rights brought about by State legislation, and this Court, finding that this legislation placed in her ownership of a share of community income, held that, after such change, she

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courts (citing cases), and this is the rule even though the state rule is not approved." See also *DeVaughn v. Hutchinson*, 165 U. S. 566; *Warburton v. White*, 176 U. S. 484; *W. T. Waggoner Estate v. Wichita County*, 273 U. S. 113.

[1]*Poe v. Seaborn*, 282 U. S. 101; *Goodell v. Koch*, 282 U. S. 118; *Hopkins v. Bacon*, 282 U. S. 122; *Bender v. Pfaff*, 282 U. S. 127; *U. S. v. Malcolm*, 282 U. S. 792.

[2]*United States v. Robbins*, 269 U. S. 315.

was entitled to report that share for Federal Income Taxation.[1]

Certainly, nothing could more clearly demonstrate the proper spheres of State and Federal laws in cases of this character than these two California cases—where, because of a change in State law regarding property, an entirely different result in the application of the Federal Income Tax Law was required.

Most directly in point on the same question are two cases recenty decided by this Court, involving the taxability of the lessee's income derived from producing oil under leases made by a state agency. One of these, the *Group No. 1 Oil Corporation* case,[2] arose in Texas; the other, the *Coronado Oil & Gas Company* case,[3] arose in Oklahoma. The Texas case related to lands belonging to the University of Texas, a state agency and institution; the Oklahoma case involved lands belonging to the Common School System. In each case, it was contended that the lessee's income from producing oil under oil and gas leases on such lands was exempt because to tax such income was in effect to tax a state agency or instrumentality. The contention of the Texas lessee was denied because *"under the setted rules of the State with respect to oil and gas leases"*[4] these leases were *"present sales to*

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[1] *United States v. Malcolm*, 282 U. S. 792.

[2] 283 U. S. 279.

[3] 284 U. S. 606.

[4] To support this statement this Court cited *Thieson v. Robinson*, 117 Tex. 489; *Texas Company v. Daugherty*, 107 Tex. 226; *Stephens County v. Oil & Gas Company*, 113 Tex. 160.

the lessees, upon the execution of the leases, of the oil and gas in place," the property thus becoming a "part of the common mass of property and subject to its burdens" so that the immunity from taxation which might otherwise apply to the instrumentality, selected by a State for the development of its public domain, could not be extended to cover property which, as was held to be the case, had *"passed to the buyer by a completely executed act of sale."*

But exemption from Federal Income Taxation was granted the Coronado Oil and Gas Company upon the income which it derived from operating an oil lease upon lands belonging to the Oklahoma Common School fund. Referring to the *Group No. 1* decision, the Court said:

> "And, as there distinctly indicated, the exemption claimed by the Oil Corporation was denied because under *the settled rule applied by the Texas Supreme Court the oil and gas from disposal of which the corporate income arose had been purchased,* not obtained under a lease—title had passed out of the State by a present sale. Status of the title was matter *for determination under laws of the State as construed and applied by her Courts.* In the present cause there is no basis for saying that, according to the local law, the transaction between the State and the lessee amounted to a sale. The distinction between cases involving sales and those where leases had been made seemed sufficiently apparent when *Group No. 1 Oil Corporation v. Bass* was decided and is not less obvious now."

In these cases, the *"status of the title"* as determined by State law was the determining factor in decid-

ing, in one case, that income from producing oil was exempt from and, in the other, that it was subject to, Federal Income Taxation.

Upon these authorities, we say that when the Supreme Court of Texas holds that oil and gas in place in Texas lands belong to the fee owner and that the effect of a certain instrument is to convey and sell that oil to the so-called lessee, those are facts to be accepted as such wherever the question of such ownership or the effect of such instrument arises. That another Court might not have so held as an original proposition, or might not have approved the reasoning which prompted the Texas Court's decision, is entirely beside the point.[1] The exclusive jurisdiction upon the question was in the Texas Court, and the owner of Texas lands has that estate in the minerals and other elements of value therein which that Court holds he has; and his written instrument with respect to such lands conveys exactly what that Court says it conveys. To those who say there is "no such animal," or that there shouldn't be; Kiplings words are a sufficient reply:

"Oh, what avails the classic phrase,
And what the cultured word,
'Gainst the untutored incident
Which actually occurred."

When we turn to Texas decisions to determine the holdings of its Courts upon these points, the answer is readily found. Perhaps it is necessary to refer to nothing

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[1] *Hines Yellow Pines Trustees v. Martin*, 268 U. S. 458, 464.

else than this Court's statements of such holdings in the *Group No. 1* case, quoted upon page 18 hereof. But going to the decisions of that State, we find it consistently held that oil and gas in place are capable of ownership, that they belong to the owner of the fee,[1] that they are

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[1]Perhaps the briefest summary of the Court's position upon these questions is contained in *Waggoner Estate v. Sigler Oil Company*, 118 Texas 509, in which the Court said: (p. 517) "The following propositions must be regarded as settled by repeated decisions of the Supreme Court: First: Such a writing as that here called a lease operated to invest the party called lessee and his assigns with title to oil and gas in place. *Texas Company v. Daugherty*, 107 Texas 226; *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Texas 160; *Humphreys-Mexia Company v. Gammon*, 113 Texas 255. Second: The estate acquired by the so-called lessee and his assigns was a determinable fee, which was lost on cessation of the use of the land for purposes of oil and gas exploration, development, and production. *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Texas 173; *Texas Company v. Davis*, 113 Texas 331; *Munsey v. Marnet Oil & Gas Company*, 113 Texas 220; *Robinson v. Jacobs*, 113 Texas 239; *Thomason v. Ham*, 113 Texas 246. Third: The estate of the lessee or of his assigns did not survive abandonment. *Grubb v. McAfee*, 109 Texas 530; *Munsey v. Marnet Oil & Gas Co.*, 113 Texas 219; *Thomason v. Ham*, 113 Texas 246. Fourth: Where a mining lease provided for oil or gas royalties and failed to define the lessee's duty as regards development after discovery of paying oil or gas, the law implied the obligation from the lessee to continue the development and production of oil or gas with reasonable diligence. *Benavides v. Huni*, 79 Texas 396; *Grubb v. McAfee*, 109 Texas 530, 531; *Texas Pac. Coal & Oil Co. v. Barker*, 117 Texas 418, 6 S. W. (2d) 1035, 1036; *Freeport Sulphur Company v. American Sulphur Royalty Company*, 117 Texas 439, 6 S. W. (2d) 1042, 1043. Fifth: Breach of the lessee's implied obligation for reasonable mineral operation will not authorize the forfeiture of the

capable of severance and sale, that the owner of the fee may divide his estate horizontally as well as vertically, that he may sell the surface and keep the minerals, or sell the minerals and keep the surface, or in short, carve out of his fee title such portion as he sees fit. And, from *Benavides v. Hunt*, 79 Tex. 396, decided in 1891, down to the present time, including the recent cases of *Theisen v. Robinson*, 117 Tex. 489, *Waggoner v. Sigler*, 118 Tex. 509, and *Ehlinger, County Judge v. Clark*, 117 Tex. 547, it has been consistently held that the effect of those instruments ordinarily called oil and gas leases is to convey to the lessee title to the oil and gas in place—to make him the owner and his title a determinable fee. The Texas Supreme Court has expressly given all such instruments that effect although one may "bargain, grant, sell and convey" the oil and gas, which another might "let, lease and demise," the property for the purpose of exploring for, developing and removing the oil and gas. That Court has expressly said that there was no basis for distinguishing between the effect of such instruments because of the language used, that the rights granted

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lease as for breach of condition subsequent, such obligation being a covenant. *Grubb v. McAfee*, 109 Texas 530; *Texas Company v. Davis*, 113 Texas 335. Sixth: The usual remedy for breach of the lessee's implied covenant for reasonable development of oil and gas is an action for damages, though under extraordinary circumstances—where there can be no other adequate relief—a court of equity will entertain an action to cancel the lease in whole or in part. *Texas Pac. Coal & Oil Company v. Barker*, 117 Texas 418, 6 S. W. (2d) 1035; *Freeport Sulphur Company v. American Sulphur Royalty Company*, 117 Texas 439, 6 S. W. (2d) 1045; *Grubb v. McAfee*, 109 Texas 534, 535."

were the same, and that it had consistently so held since *Benavides v. Hunt.*[1]

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[1]In *Stephens County v. Oil & Gas Company*, 113 Tex. 160, the Court said, at p. 172: "We find it impossible to reasonably ascribe to the two sets of instruments, disregarding mere form and looking at substance, any different legal effects as regards the transfer of title to the oil and gas in place. Notwithstanding the distinctions attempted to be drawn in the decisions, we cannot conclude otherwise than that there is no real difference in the title conveyed, whether an instrument takes the form of a grant of the exclusive right to mine and appropriate all of a certain mineral—as in *Benavides v. Hunt*, supra—or takes the form of a demise of the land, for the sole purpose of mining operations coupled with a grant of the exclusive right to produce and dispose of the mineral—as in this case—or takes the form of a grant of the mineral with the exclusive right to mine for, produce, and dispose thereof—as in *Texas Company v. Daugherty*, supra. The results are substantially the same to all parties at interest, whether the one or other form of instrument be used. Why hold that instruments in different forms create different estates, where there is no difference in fact with respect to that of which each divests the grantor, his heirs or assigns, nor with respect to that with which each invests the grantee, his heirs or assigns?"

It should also be noted that the same holding is reached whether the royalties are payable in money, as they were in the *Theison case*, or at the option of the lessee in money or oil, as in the *Stephens* case, or in oil, as they were in the *Ehlinger* case, and as they are in this case. Upon this point, the Court said in the *Ehlinger* case, (p. 558): "We think the purchase price is the $4,000.00 evidenced by the notes specified in the contract and one-eighth of the oil, not as it existed in place, but after, by the expensive process of exploration, drilling, and production, the oil has been captured and reduced to possession, produced at the surface of the earth, and delivered at the intake of the pipe line as personalty. * * * (p. 563) We are unable to find any practical difference

The Courts of Texas give substance to these holdings. It is not simply a question of creating a particular estate by calling it by that name. It is there held that the lessee's estate is subject to ad valorem taxation as real estate, in the County where the land is situated.[1] The formalities required to convey by deed are required to make an oil lease;[2] If the land covered is a homestead, the wife must join and privily acknowledge the instrument in the same way as if the entire homestead were being sold.[3] The Statute of Frauds applies to all contracts relating thereto.[4] The lessee has the right of exclusive possession to the extent necessary to enjoy his estate. All necessary easements, if not expressly granted, are implied.[5] The interests of the lessee can be mortgaged, a vendor's lien is frequently retained against it

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between the payment made in money, in amount equal to one-eighth of the oil produced, and the actual payment in oil, a commodity which we know is readily convertible into cash. If the one is a diversion of the school fund, the other is necessarily such a diversion—but, neither is a diversion. The contract before us is simply the usual one made generally over the country by those who sell mineral rights, and well within the constitutional powers of the Commissioner's Court to make."

The lease involved in the *Ehlinger* case is set out in full in the Court's opinion, pp. 550 to 552, and it will be found to be practically identical with those involved in this case.

[1]*Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Tex. 160; *Waggoner Estate v. Wichita County*, 273 U. S. 113.

[2]*Hager v. Stakes*, 116 Tex. 453.

[3]*Southern Oil Company v. Colquitt*, 69 S. W. 169.

[4]*Green v. Priddy*, 112 Tex. 567.

[5]*Campbell v. Schrock*, 10 S. W. (2d) 165.

when created or transferred, mechanics and materialmen may acquire the usual liens thereon.[1] Only under most unusual circumstances is it subject to cancellation,[2] and it can endure until every element which gives it value is exhausted—that is, until the thing actually sold, the mineral content, is entirely removed and appropriated.

Oil and gas leases and assignments thereof come within the purview of registration statutes.[3] The Statute which specifies those covenants which are implied in "conveyances" apply to such instruments.[4] The Statute which denies a tenant the right to sublet without the written consent of his landlord is not applicable to an oil and gas lease.[5]

In applying the statutes which define and limit the separate and community estate of a husband and wife, oil and gas leases are treated, as are all other conveyances of real estate, and the proceeds derived are classified as separate or community in the same way that they would be classified were these proceeds derived from the sale of the entire fee simple title to the property.[6]

In his brief the Petitioner takes the position that *Stephens County v. Oil & Gas Company*, 113 Texas 160, decided in 1923, changed the rule in Texas as to the nature of an oil and gas lease and the estate conveyed thereby.

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[1]Articles 5473-5479, Revised Statutes of Texas, 1925.
[2]*W. T. Waggoner Estate v. Sigler*, 118 Tex. 509.
[3]*English v. Plumlee*, 291 S. W. 922.
[4]*White v. Murphy*, 229 S. W. 641.
[5]*Gladys Belle Oil Company v. Turner*, 12 S. W. (2d) 847.
[6]*Stephens v. Stephens*, 292 S. W. 290; *Ferguson v. Commissioner*, 45 Fed. (2d) 573.

This is stated on page 15 of Petitioner's brief. We submit that this statement is entirely incorrect, and that this Court, both in *Group No. 1* and the *Coronado Oil & Gas Company* cases, recognized that the rule in Texas had been long continued, that it was a rule of property, that it was the "settled rule." Certainly the Supreme Court of Texas has announced so frequently that this was its consistent holding, from *Benavides v. Hunt*, decided in 1891, to *Waggoner v. Sigler*, 118 Texas 509, that he who makes an assertion to the contrary is bold indeed. We are sure that this Court is not interested in the interpretation which the intermediate appellate courts of Texas may have placed upon such instruments, and upon the decisions of the Supreme Court from time to time, since the Supreme Court has spoken so emphatically upon the subject. To refute Petitioner's assertion upon this point, we are content to ask the Court merely to examine *Benavides v. Hunt*, 79 Texas 396, *Southern Oil Company v. Colquitt*, 69 S. W. 169 (writ of error denied), *Texas Company v. Daugherty*, 107 Texas 226, *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Texas 160, *Theisen v. Robinson*, 117 Texas 489, *W. T. Waggoner Estate v. Sigler Oil Company*, 118 Texas 509.

We likewise submit that, entirely apart from the rules of Texas upon the subject of oil and gas leases, it must be held that such instruments constitute sales of capital assets under Section 208. If oil and gas in place is not considered capable of ownership, it is nevertheless, everywhere held that a land owner's rights thereto consti-

tute valuable property rights.[1] This Court has held, quite recently, that such rights are property.[2] This undoubted right to explore for, reduce to possession, and dispose of, is everywhere a valuable property right, the subject of barter and sale, and the basis of enormous financial transactions, having every element of property, as the term is ordinarily used. Every Court protects it as property. Everywhere, instruments such as those involved in the case at bar, are held to transfer and convey valuable property rights. Nothing more is needed to make such transactions sales of capital assets.[3] "Property" as used in Section 208, is not confined to real estate or chattels. Obviously, it applies to stocks, bonds, other choses in action, to patents, to copyrights [4]and similar intangibles.

Nor is the fact that the rights granted are sometimes subject to cancellation of moment. That was an incident

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[1]*Forbes v. Gracey*, 94 U. S. 462.

[2]*Lynch v. Alworth-Stephens Co.*, 267 U. S. 364.

[3]Against this it may be argued that since oil and gas in place is not subject to ownership, in such jurisdictions the period of time between oil and gas being reduced to possession and the sale is not sufficient to bring the time of actual ownership within the statutory limitation of two years. Cf. *Alexander v. King*, 46 Fed. (2d) 235. But this theory can have no application here. If we discard the theory of ownership of oil and gas in place, then the thing actually sold by the instruments in question is the right to explore and reduce to possession, which has co-existed with the fee title since its original acquisition.

[4]In *I. T. 2169*, Cum. Bull. IV-1, page 13, the sale, in 1924, of the motion picture rights to a play written and copyrighted in 1921 was held to be a sale of capital assets under the 1924 law. In *A. W. Henn v. Commissioner*, 20 B. T. A. 1133, real estate leases in the hands of the lessee were stipulated to be capital assets (p. 1151).

of all estates at early common law.[1] Such instrumentalities have from time immemorial been used to develop minerals of all kinds, and for that long have been recognized as valuable, defeasible, vested property rights, the subject of barter, sale, inheritance and taxation, granting the exclusive right to use, possess and consume at least a portion of the minerals.[2] This Court will not read limitations into

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[1]*Castillero v. U. S.*, 2 Black 169, 17 L. Ed. 380.

[2]In the *Theisen* case the Supreme Court said (page 504): "Mr. Lindley traces far beyond the dawn of our present civilization the custom of sales for royalties of minerals, such as tin, iron, and coal, apart from the balance of a tract of land containing same, and points out that the vendee of the minerals acquired an estate in the land subject to the payment of debts. Discussing the oldest mines in England, once worked by the Romans, Mr. Lindley says: 'The right of working the tin mines of Cornwall was conferred upon all free tinners upon the render of a certain portion of the minerals raised to the owner or lord of the soil. This portion was called dish or toll tin, and was usually one-fifteenth of the production. Any tinner was allowed to 'bound' any unappropriated waste lands or enclosed lands which had formerly been waste subject to this custom. He 'bounded' the same by the delivery of toll tin to the lord of the soil. * * * * The bounds might be sold or demised, and were frequently farmed out for a render called farm tin, and were liable for the payment of debts and legacies. The estate was in the nature of a chattel real, and passed to the executor.' *Lindley on Mines* (2d Ed.) sec. 5, pages 9 and 10. After tracing the custom to realize on minerals by means of separate sales thereof for royalty from ancient England to the American States, Mr. Lindley states: 'Under the English law, rights of property in the surface and in the underlying mines might be shown to be in different owners. Nothing was more common than to sell or demise a piece of land excepting the mines. In like manner the different strata of the subsoil might be shown to be the subject of different rights. And

this taxing statute where none exist; but will determine that the rights transferred by these instruments were valuable property rights owned by Harmel for more than two years, and that, when he transferred them for a substantial consideration in cash, he made a sale within the ordinary meaning of that term.

These conclusions are supported in many other ways. The capital gain method of taxing profits was first introduced in the 1921 Act. It was brought into being by the obvious injustice of taxing at progressive rates in one year gains which, though realized in that year, were really the fruit of a longer investment. Certainly Congress had transactions like these in mind when the Committee on Ways and Means said in recommending and reporting the Section (H. R. 350, 67th Cong. 1st Sess. pp. 10-11):

Capital Gain and Capital Loss

"Section 206: The sale of farms, *mineral properties*, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is

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there might be also in one mine different minerals which were the property of different persons. Thus, one person might be entitled to the iron, and another to the limestone. When the surface and underlying mines or the different strata of the subsoil were differently owned, they were separate tenements, with all the incidents of separate ownership—a distinct possession and distinct inheritance; and the mines of each stratum might be held in fee simple, or fee tail, or otherwise, as in the case of surface property.' *Lindley on Mines* (2d Ed.), sec. 9, pages 14 and 15."

realized. Many such sales, with their possible profit taking and consequent increases of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

The report of the Senate Committee on Finance was in substance the same. Senate Report No. 275, 67th Cong., 1st Sess., pp. 12-13.

The language of Section 206 of the 1921 Law is, in all pertinent respects, identical with Section 208 of the 1924 Law and the corresponding sections of later laws.

Important, too, is the fact that a lessee is allowed and required to treat the bonus paid the land owner as the cost of his interest in the minerals.[1] This cost is the primary basis of his depletion allowance and, in case of a subsequent sale or disposition of the interest acquired, the basis for determining the gain or loss resulting therefrom. Certainly that which is "cost" to lessee is "selling price" to the

[1]Regulations 65, Article 203.

lessor to whom it is paid and is for the interest, the cost of which is so fixed, acquired.

The lessor, in turn, was required to use an aliquot portion of the sum so received to absorb his cost or basis and depletion on later royalty payments was allowed only to the extent of the reduced basis. The method was changed by T. D. 3938, but the princple remains the same.[1]

The rules here urged have been applied by the Treasury Department for many years in situations which cannot be distinguished from that presented by the case at bar. From the Revenue Act of 1918, through the Revenue Act of 1924,[2] (the Act here under consideration) and again by the recent Act of 1932,[3] a stamp tax was imposed upon any "deed, instrument, or writing whereby any lands, tenements or other realty *sold* shall be granted, assigned, transferred or otherwise conveyed to, or vested in, the purchaser or purchasers, etc." It should be borne in mind

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[1]Regulations 65, Article 216. These, with other pertinent Regulations are set out in the Appendix, see page 72 hereof.

This, in recent years, has been largely theoretical, as the Bureau of Internal Revenue has been allowing no depletion or other deduction since *Murphy Oil Company*, 15 B. T. A. 1195. None was allowed in this case, nor was any allowed in the *Ferguson* case, 45 Fed. (2d) 573. No case, it is believed, can be cited which shows that any depletion deduction has been allowed a lessor on the consideration or "bonus" received for a lease.

[2]Title IX, Sec. 1100 and Schedule A (7) Revenue Act 1918. Title XI, Sec 1100 and Schedule A (6), Revenue Act of 1921. Title VII, Section 800 and Schedule A (5), Revenue Act of 1924.

[3]Section 725, Revenue Act of 1932.

that this language was in the very act here under consideration, that it had been in the two previous acts, and was again incorporated into the 1932 Act. Here, again, the basis is the act of selling; only those instruments conveying realty, etc., "*sold*" were to be stamped. But the Bureau of Internal Revenue, beginning with Regulations promulgated for the enforcement of the 1918 Act, consistently held that State law was determinative of what was realty and whether a sale had been made.[1] In entire consistency with this, it held that, in those states where oil leases were considered sales of realty, stamps must be affixed to leases and assignments thereof,[2] while in those states where different rules prevailed, stamps were not required.[3] Thus leases and assignments of leases on Texas lands were stamped from 1918 until 1926, (the entire Stamp Tax on conveyances was omitted from the 1926 Act) while instruments of identical verbiage on lands in Oklahoma and Louisiana went untaxed.

Since the passage of the 1932 Act, Regulations of the same purport, making state rules of property the deciding factor, have been promulgated[4] and an express ruling holding that an oil and gas lease on Texas land, similar to

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[1]These Regulations, including those adopted under the 1932 Act, are set out in the Appendix, pp. 75-78.

[2]*S. M. 4439*, Cum. Bul. IV-2, page 52. "Under the laws of Texas the interest conveyed under the oil lease constitutes an interest in real property and the instrument is subject to the Federal Stamp Tax imposed by Schedule (a) (5) Title VIII of the Revenue Act of 1924." See also ruling under 1932 Act set out in the appendix.

[3]For example, *G. C. M. 913*, Cum. Bul. V-2, page 255, dealing with Louisiana.

[4]Appendix pp. 72-78.

those in this record, must be stamped because it conveys an interest in realty, has been issued.[1]

We can only leave it for Petitioner's counsel to explain why a transaction, which, under one section of the law, constitutes a sale of realty, does not, under another section of the same law, constitute a sale of "property."[2]

We have heretofore referred at sufficient length to the principles decided by the *Community Property Tax* cases, by the *Group No. 1* and the *Coronado* cases. Another example of State law and its relation to Federal taxation is *Crooks v. Harrelson*, 282 U. S. 55, where the State law regulating the property of a decedent subject to the payment of debts and expenses of administration was given effect in determining the net estate of a decedent subject to a Federal Estate tax. *U. S. v. Cambridge Loan & Building Company*, 278 U. S. 55, applies the same principle.

The conclusion is unescapable that, since Congress did not limit the general terms which it used in Section 208, but made a taxpayer's rights thereunder depend upon whether property was sold, we must look to State rules of property—in this case—Texas—to determine whether the taxpayer owned property and whether that property was

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[1]See Appendix page 76.

[2]In his brief the Petitioner says (page 32): "Putting the Texas decisions aside, it is still true that even though oil and gas lease does not amount to a conveyance of the oil and gas in the ground, it does amount to a conveyance of an interest in the land. *Ewert v. Robinson*, 289 Fed. 740, 750, (C. C. A. 8th)." What more is necessary, we submit, to make it a conveyance of property?

conveyed. When this test is applied, by the ruling of this Court, and the Supreme Court of Texas, only one answer can be made. *Property was sold.*

II.

We submit that it is entirely unnecessary to speculate as to the sense in which Congress used the word "sale" in the Capital Gain Section of the law; and that it cannot be argued that Congress intended to include some sales and exclude others. (See Petitioner's brief, pp. 15-19). The word is used without qualifying language and no rule of construction warrants qualification by implication, particularly in a taxing statute. We cannot indulge the presumption that Congress did not realize that, when not qualified "at all times, it (sale) means a contract between parties to give and to pass rights of property for money." *Williamson v. Berry*, 8 How. 495, 544.

But, if we were to seek a determination of the sense in which Congress used the term, the necessary conclusion is directly opposite to that reached by Petitioner in his brief. In another title of the law, the word "sold" is used under circumstances which require its application to oil and gas leases; and in the same title, there are provisions regarding the depletion allowance applicable to oil properties which make it necessary to fix the treatment of the bonus paid for an oil lease. By examining these, we can throw some light upon the question of whether Congress understood and intended that "sale" should include the making of an oil lease. This will be all the more helpful because the same language was in both the 1918 and

1921 laws, and had received the same construction since the 1918 Act was adopted.

We have already seen that, by Schedule A (7) Sec. 1100, Title IX of the 1918 Act, stamps were required upon a "writing whereby any lands, tenements or other realty *sold* shall be granted * * * * to the purchaser * * * * or purchasers"; that the same language was used in the 1921 and 1924 Acts; and, after being omitted from the 1926 and 1928 Acts, were reincorporated in the 1932 Law (31-34 hereof). Likewise, we have seen that this has been consistently applied from 1918 to date to include oil leases in Texas, on account of the very rule of State law upon which we rely here; and to exclude oil leases in those states where no interest in real estate was conveyed. This construction of the word "sold" in the 1918 Law has received Congressional sanction by three separate re-enactments, one in the very law with which we are here concerned.

If we must seek Congressional intention, how can we say that by using the word "sale" without limitation in the 1921 and 1924 Capital Gain Section, Congress did not intend it to have the same meaning as "sold" used in the same laws, and that this meaning was not the same as that which it was approving at that very time by re-adopting the stamp tax title of the law?

The depletion section of the law strongly supports this. Again we have the same language used in the 1918, 1921, and 1924 Acts and construed in the same way under all three Acts. In the 1918 Law (Sec. 214 (a) (10)) it is provided that, in computing net income, there shall be allowed as a deduction:

> "In the case of mines, oil and gas wells * * * * * a reasonable allowance for depletion and for depreciation of improvements * * * * * based upon *cost* including cost of development not otherwise deducted * * * * *. Provided further, that in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of *purchase* of a proven tract or *lease*, where the fair market value is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value, etc. * * * * * In the case of leases, the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

The last sentence shows Congress had lessees in mind. In fact, many of the allowances provided for the subdivision were denied lessors until authorized by an opinion of the Attorney General.

The first provision is that the allowance should be based "upon cost including cost of development not otherwise deducted." Other than development costs, what other "cost" could there be except the bonus—paid the lessor in all of those cases where the lease was acquired directly from the land owner? If the "bonus" is "cost" to lessee, can it be anything but "selling price" to lessor? Is the word apt to describe rentals, license fees, or payments of that sort?

"Cost" is used again in the "discovery" portion of the subdivision, and in connection with the phrase "*purchase* of a proven tract or *lease*." We submit that these excerpts show plainly that Congress regarded transactions like those here involved as sales between the lessor and lessee; "cost," "purchase," "acquisition" can have no other mean-

ing. They furnish unmistakable criteria to determine how Congress intended that the word sale, in the same law, should be construed, and applied.

This view is emphasized by the treatment of these statutory provisions in Regulations 45, adopted for the enforcement of the 1918 Law. It is there stated:

> "Art. 201: * * * * The essence of these provisions of the Statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions. * * * * * The term 'basic date' indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery or within thirty days thereafter in the case of discovery. * * * * *"

> "Art. 203. Capital recoverable through depletion deductions in the case of a lessee—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions. * * * * * (d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost. (e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within thirty days thereafter, of his equity in the mineral discovered."

"Art. 205. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral right or leasehold was acquired, the owner or lessee will be required to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale, by which the property passed to an owner in fact as well as in form other than the vendor."

The original treatment of a bonus required of a lessor is provided in Article 215, where it is said:

"(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of the lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining, the difference may be recovered through depletion based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Without further extending these quotations, we affirm that the Regulations regarding depletion, from Article 201, p. 76, through Article 237, p. 100, cannot be read without the reader being forced to the conclusion that at all times the Treasury Department has treated the bonus paid by a lessee to a lessor as the lessee's cost and as the selling price of the lessor, and the transaction

as transferring the interest, specified in the instrument, in the mineral content, from the lessor to the lessee; and as creating, to the extent of the bonus, a capital investment upon the part of the lessee and as reducing the capital investment of the lessor.

When it is remembered that substantially the same Regulations were passed for the enforcement of the later Acts, which contain the same language in the depletion section, and when thereby this treatment was given repeated Congressional approval, it is again conclusively demonstrated that Congress understood and approved of the treatment of oil and gas leases as sales.

We know of no other sections in the law which will throw any light upon Congressional intention, and, if it is proper to attempt by such standards to construe the word "sale," when it is used without qualification, we submit that from no source, from which Congressional intention can be gathered, can any inferences be drawn which will exclude from that word's meaning, transactions like those before the Court here.

III.

Thus far, we have attempted, in the main, to deal affirmatively with the question presented. We will now endeavor to take up the authorities and reasoning urged to support the contrary view.

We submit that the Petitioner's entire argument is predicated upon a false premise, which is clearly disclosed in the statement of the question presented. He there says that the question is whether or not cash bonuses

"paid as advanced royalties" constitute income from the sale of capital assets, etc. We submit that the so-called bonus was not paid as an advanced royalty. It was the consideration for the estate granted. The instruments themselves make this entirely clear. The provisions contained in such instruments, regarding royalties, are entirely separate and distinct from, and independent of, the provisions stating the consideration for the grant. The whole theory of Texas law relative to oil and gas leases refutes any such contention. Without the cash consideration, most oil and gas leases in Texas would be unilateral and of no force and effect, and the Courts of Texas have been frequently called upon to determine whether or not the consideration paid in cash, upon the execution of such instruments, was adequate and sufficient to support the grant. A discussion of this, with numerous cases showing its application, will be found in Thuss on Texas Oil & Gas, Section 46, p. 68.

Probably the first Court decision upholding the Petitioner's view is the case of *Hirschi v. U. S.*, 67 Ct. Cls. 637, decided May 6, 1929, in which this Court denied certiorari, 280 U. S. 576.. In no material respect does that case differ from the one at bar. The 1921 Act was involved, rather than the 1924, but the applicable provisions of both Acts are the same. The property involved was situated in Texas.

The Court of Claims first said that since *Stratton's Independence v. Howbert*, 231 U. S. 399, "the proceeds received from such leases of oil and mineral lands were to be treated as gross income"; that the Board of Tax Appeals had consistently held "tnat sums received as

bonus or royalties from such leases of oil and mineral rights were not income from the sale or exchange of capital assets but gross income. We hold it to be gross income."

As to the Texas rules regarding oil leases, it was said that such rules were against the weight of authority, and the decisions of this Court. The opinion continued:

> "To say that the holding of the Supreme Court of Texas upon the application of this principle to a given state of facts is sufficient to control the United States Courts in the construction of the United States Revenue Act in the face of the contrary application of the principle by the United States Courts is too untenable to require discussion."

Then, after saying that state rules of property governed in certain matters, the Court said that "the State decisions cannot control on a question of general jurisprudence as in this case."

The Court cited its own decision in *Steedman v. U. S.*, 63 Ct. Cls. 226, in which, in applying the Federal Estate Tax, it refused to give effect to the laws of Missouri regarding the sale of a decedent's real estate for the payment of debts; cited *Burk-Waggoner v. Hopkins*, 269 U. S. 110, and closed by referring to the fact that the Federal Government, in its selection of subjects for taxation, was not limited by the construction placed by State Courts upon property rights, that it was—

> "Not called upon to suit the revenue system of the country to the varying and conflicting decisions and laws of the different states,"

That—

> "Where the constitutional powers of the Federal Government and the States conflict, those of the States must give way."

These excerpts show the ratio of the *Hirschi* decision and, at the same time, cover the major points of later decisions and the arguments most frequently urged against Respondent's position. Perhaps the only authority in point cited by the Court of Claims is that Court's decision in *Steedman v. U. S.*, 63 Ct. Cls. 226 (in which this Court denied certiorari). As to this, it is sufficient to say that the identical question later reached this Court in *Crooks v. Harrellson*, 282 U. S. 55, and this Court there reached exactly the opposite conclusion and did exclude certain real estate from the gross estate of a decedent subject to Federal Estate Tax because the law of Missouri did not make such real estate subject to the payment of debts and the expenses of administration; although in other states, where the State law is different, real estate is taxed.[1] Petitioner cannot comfort from that portion of the *Hirschi* decision.

Nor is the decision of this Court in *Burk-Waggoner v. Hopkins*, supra, cited by the Court of Claims, applicable. No question is involved here of the power of

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[1]Cf. *First Trust Company of Omaha v. Allen* (District Court of Nebraska), 51 Fed. (2d) 1069, where, because of the difference in State Law; Missouri lands were not included as subject to the Federal Estate Tax, while land belonging to the same estate in Nebraska and Iowa were included. Affirmed by the 8th C. C. A., 51 Fed. (2d) 1069.

Congress in selecting subjects for taxation. We have never thought of contending that Section 208 could not have been framed so as to exclude transactions like those here involved, regardless of State law, and at the same time include other transactions. By the same authority which enabled Congress to define a capital asset as property held for two years, and to exclude stock in trade or property ordinarily included in inventory from the benefits of the capital gain section;[1] the line could have been drawn to exclude the income derived from making an oil and gas lease. But that is a question of power, with which we are not here involved; ours is the easier task of determining what Congress has done, rather than what it can do. The *Burk-Waggoner* case, on the other hand, was directly concerned with whether Congress could segregate joint-stock associations—classified as partnerships under State law—from ordinary partnerships, and tax the income of one differently from that of the other without violating constitutional restrictions. That this Court held that this could be done, in no way aids in the determination of what Congress did do in Section 208 of the 1924 Act.

Again, based upon *Stratton's Independence* and related cases, the Court of Claims held in the *Hirschi* case that sums received "as a bonus * * * from such oil or mineral leases were not income from the sale or exchange of capital assets, but gross income." The first criticism of this is the apparent holding that "income from the sale or exchange of capital assets" is not "gross income," and the attempt to place those situated as Respondent is

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[1]Section 208 (a) (8), Revenue Act of 1924.

in the attitude of contending that such income is not subject to taxation. Of course, no such contention is made. The sum in question must be "income" and taxable under the general definition of income in the statute[1] before the question of whether or not it is a capital gain can arise. The items in question are "gross income" because there is, under the facts of this case, nothing of cost to deduct from the selling price. We have always admitted that the $57,000.00 in question was "gross income"; it also happens that the entire sum is "net income." We say that, in all cases, the gain from the sale or exchange of capital assets is gross income. Any contrary view, no doubt arising from *Gray v. Darlington*, 15 Wallace 63, and the conception of income under English Income Tax laws,[2] if not set at rest by the very terms of the 16th Amendment and this Court's decisions under the 1913 Act,[3] was certainly disposed of by *Merchants Loan & Tr. Co. v. Smietanka*, 255 U. S. 509, decided by this Court in 1921.[4] In truth, the determination that the sum in question is gross income, invokes, rather than answers, the question here. Is it that character of gross income which under Section 208, is derived from the sale or exchange of a capital asset?

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[1]Section 213, Revenue Act of 1924.

[2]*Merchants Loan & Trust Company v. Smietanka*, 255 U. S. 509, 521, 522.

[3]*Brushaber v. Union Pac. Ry. Co.*, 240 U. S. 1; *Stanton v. Baltic Mining Company*, 240 U. S. 103; *Southern Pacific v. Lowe*, 247 U. S. 330; *Lynch v. Turrish*, 247 U. S. 22.

[4]See also *Eldorado Coal & Mining Company v. Magar*, 255 U. S. 522; *Goodrich v. Edwards*, 255 U. S. 527; *Walsh v. Brewster*, 255 U. S. 536.

The authorities heretofore discussed (pp. 17-20 hereof) would seem to be a sufficient answer to the pronouncements of the Court of Claims that the State laws cannot control the selection of objects of Federal taxation. In addition thereto, we do not contend, and we have never contended that State legislation or decisions can control the Federal taxing power, or the selection by Congress of objects of taxation. Certainly this Court has announced too plainly and frequently that the taxing power granted to the general government was limited only by the terms of the Constitution itself, for any one to question it now, and we disclaim any intention of so doing. But just as plainly, has the power and intention of Congress to relate the exercise of the taxing power and the subjects taxed to state property rules been upheld by this Court, where the language used by Congress, fairly construed, expressed that meaning. That, we contend, has been done here.

There are many examples of this. The *Community Property* cases, heretofore discussed (p.17) are directly in point. The basis of the whole income tax, as it related to individuals, was involved. The thing taxed was the "net income of every individual." The basic question was where to look to determine what made income that "of" a particular individual. Just as we assert should be done in this case, the Court there put the ordinary, general meaning of the word "*of*" as denoting ownership, and continued:

> "The Commissioner concedes that the answer to the question involved in the cause must be found in the provisions of the laws of the State, as to a wife's

ownership of, or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor? *Poe v. Seaborn*, 282 U. S. 101.

This concession is a concession of the very principle for which we contend here.[1] When the general question of ownership is involved in relation to Federal tax matters, and Congress has not, by definition or limitation fixed the standard to be applied, State law is the only standard that can be applied. So here, the basic questions are what interest did Harmel have in the oil and gas prior to the execution of the leases, and what interest was conveyed by the leases? Does the interest, originally owned by Harmel constitute "Property"? Did property pass for a consideration by virtue of the execution and delivery of the instruments? Here again, as in the Community Property cases, the Commissioner should concede that the answer is to be found in State law.[2]

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[1]It is difficult to understand how ownership can be determined by one standard and a transfer of ownership by another, when the latter is nothing but an inquiry into the ownership before and after a given transaction.

[2]It is entirely clear that we are not seeking an exemption from taxation, but rather to determine under which one of two classifications—the one advantageous, the other burdensome—it is proper to place Harmel's income. Since this Court has repeatedly extended the rule of strict construction of taxing statutes, even to limitation in favor of the taxpayer *(U. S. v. Michel*, 282 U. S. 656, *U. S. v. Updike*, 281 U. S. 489), we see no reason whatsoever why the law should not be construed strictly in favor of the taxpayer, as in the ordinary case, rather than strictly against him, as suggested by Petitioner (p. 19, Petitioner's brief).

Crooks v. Harrellson, 282 U. S. 55, heretofore referred to, is another application of the general principle. There, because the Revenue Act related the property of a decedent to be included in his gross estate, to the property subject to the payment of debts and the expenses of administration, State rules upon the latter question were given effect, and real estate excluded. This was done although, in many other, and, perhaps, the majority of states, property of the same character would have been taxed.[1] And it is important to note, in illustration of the rule, that later Federal Estate Tax laws, by changing the definition of property to be included in the gross estate, avoided the application of this State rule,[2] just as California met the test of the unchanged phrase—"net income of every individual"—by changing her community property laws to confer ownership of a share of the community property upon the wife.[3]

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[1]*First Trust Company of Omaha v. Allen*, 52 Fed. 1069.

[2]The 1918 Act was involved in the *Harrelson* case. There it was provided in Section 402 "That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—(a) to the extent of the interest therein of the decedent at the time of his death, which, after his death, is subject to the payment of the charges against his estate and the expenses of its administration, and is subject to distribution as part of his estate." The same language was used in Section 402 of the 1921 Act and Section 302 of the 1924 Act, but in the 1926 Law (Section 302 (a)) this was changed to read simply "To the extent of the interest therein of the decedent at the time of his death."

[3]*U. S. v. Robbins*, 269 U. S. 15; *U. S. v. Malcolm*, 282 U. S. 792.

The *Cambridge Loan and Building* case[1] applied the same principle. There those associations regarded by State law as mutual Building and Loan Associations were exempted from Federal Income taxation under a clause which exempted "Domestic building and loan associations and co-operative banks organized and operated for mutual purposes and without profit."[2]

As heretofore pointed out, the Petitioner is today applying it with respect to stamp taxes on oil and gas leases, and assignments thereof, and, in effect, saying in one breath that we must look to the State law to determine whether *realty* is *sold*, and in the next, that we cannot, under the Capital Gain Section of the same Act, look to that law to determine when property is sold or exchanged.[3]

Weiss v. Weiner, 279 U. S. 333, has been sometimes cited as opposed to this rule. But an examination of it, particularly in the light of the decisions below, 17 Fed. (2d) 650 and 27 Fed. (2d) 200, will show that it does not conflict with and, perhaps, supports our view. Weiner dealt in 99-year leases on Ohio property. He acquired several without cost, all being acquired subsequent to March 1, 1913. He was obligated to pay rental, to maintain and, in some cases, to improve. He had in each case an option to surrender and be released of further obligation. He sublet the premises so leased. At the time of the trial, about half of the leases had been surrendered or had been assigned in such a way as to relieve him of

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[1]278 U. S. 55.
[2]Sec. 231 (4), Revenue Act of 1918.
[3]See pp. 31-33 hereof and Appendix pp. 75-78.

further responsibility. In the tax years in question, he was allowed to deduct all expenditures for repairs and depreciation upon the cost of all improvements placed upon the properties by him. He sought, in addition, a depreciation deduction based upon the value at the time his leases were obtained of the improvements upon the leased properties. This was denied. It is clear from a reading of all of the opinions in the case that this was denied because the familiar statutory provision for the allowance of depreciation (formulated in the 1909 Excise Tax Law and unchanged since), had always been construed as a provision to restore through annual allowances the gradual loss of capital invested in (or the March 1, 1913, value of) depreciable assets,[1] and where, as there, no capital investment had been made, there was nothing to depreciate. Weiner was not allowed to anticipate and accumulate tax free a reserve against a contingent liability to invest, improve or restore, particularly where experience had demonstrated that it was improbable that he would ever be called upon to invest the reserve in that way. In concluding the opinion in the case, this Court said, through Mr. Justice Holmes:

> "It does not matter that in Ohio, where the properties lie, these long leases are treated as in many respects like conveyances of the fee. The Act of Congress has its own criteria, irrespective of local law, that look to certain rather severe tests of liability and exemption and that do not allow the deductions demanded whatever the lessees may be called. We understand this to be the view taken by the De-

[1] *Ludey v. U. S.*, 274 U. S. 295; *Thompson Oil & Gas Company v. U. S.*, 283 U. S. 301.

partment for a long time and we are of the opinion that it should not be disturbed."[1]

Under the circumstances of that case, it would not have mattered if the instruments had, in fact, been conveyances of the fee, rather than in many respects, like such conveyances. The basic question, under the test laid down by Congress, was whether the taxpayer had a capital investment in the property. Since he had not, there was from his standpoint nothing to depreciate, and it truly mattered not what construction the laws of Ohio placed upon the instrument, since no construction could take the place of the capital investment required by the Act of Congress. Here Congress had supplied the test, and, of course, such test governed; in the case at bar, the test was not supplied, the question was left for determination by local law, and to that law we must look.

That this may produce a lack of unformity, as it certainly does, is immaterial. It did not prevent the Texas lessor or assignor from paying stamp taxes, when his neighbor in Oklahoma did not; it did not prevent the Missouri citizen from escaping the estate tax on certain real estate, when the Texas citizen did not; nor did it prevent the lessee of University of Texas lands being taxed upon his income therefrom, when the lessee of Oklahoma School lands was exempted. Nor will it prevent Congress, if it sees fit to do so, from limiting the scope of the Capital Gain Section and, in the future, excluding from its benefits transactions like those here involved—

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[1]We do not see how this can be construed as a refusal to follow the local law as contended by the Petitioner (p. 30, Petitioner's brief).

as it did in the Missouri situation dealt with in *Crooks v. Harrellson.*

> "The answer to such argument, however, is, that the constitutional requirement of uniformity is not intrinsic, but geographic. * * * And differences of state law which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity. *Florida v. Mellon*, 273 U. S. 12."[1]

Poe v. Seaborn, 283 U. S. 101.

We turn to some of the other cases cited in the *Hirschi* and similar decisions.

The first of the cases ordinarily relied upon by the opposition is *Stratton's Independence v. Howbert*, 231 U. S. 399, decided December 1, 1913. The facts and questions there presented are entirely different from those at bar. Stratton's Independence was a mining company conducting mining operations on lands owned in fee. The Act involved was the 1909 Corporate Excise Tax law. The case came to this Court on the following certified questions:

> "(a) Did the Act apply to mining companies?
>
> (b) Are the proceeds of ore mined from its own premises income to the mining company within the terms of the 1909 Act?

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[1]See, also, *Phillips v. Commissioner*, 283 U. S. 589 (602), where the Court said: "The extent and incidence of Federal Taxes not infrequently are affected by differences in State laws; but such variations do not infringe the constitutional prohibitions against delegation of the taxing power, or the requirement of geographical graphical uniformity."

(c) If so was the Company entitled to deduct as *depreciation* the value of the ore in place before it was mined? (Note that the right to deduct cost of the ore in place as depletion was not involved).

This Court said that mining companies were within the terms of the Act, and that they were doing business so as to come within the terms of a tax levied upon the right to do business in a corporate capacity, that the proceeds of the ore mined were undoubtedly "gross income" within the definition of the statute.

In passing upon the depreciation question, the Court pointed out that the Company had deducted from gross receipts the moneys expended in extracting, mining and marketing the ores and "the precise difference was taken to be the value of the ores when in place in the mine." The Court pointed out how this disregarded the cost of the property, and the fact that many times the original cost or market value might be yielded, and disregarded, also, the fact that the Act was designed for practical revenue purposes. Next, it was stated that it was improper, assuming depletion should be taken into consideration, to estimate its amount by the method used—selling price less cost of extracting and marketing. The Court then refused to go further into the question of depreciation. (Three Justices dissented on the third question).

It is impossible to read into this decision anything which has any bearing upon the question at bar—Does a land owner sell property when he executes an oil and gas mining lease? We are not here concerned with the income derived from producing oil—or the depletion and

depreciation deductions to which a producer is entitled, nor do we contend that producing oil—or selling any property for more than cost—does not produce taxable income.

Stanton v. Baltic Mining Co., 240 U. S. 103, next in point of time in this series of cases, arising under the 1913 Income Tax law, insofar as it was not disposed of by the decision in *Brushaber v. U. P. R. Co.*, 240 U. S. 1, dealt solely with whether the asserted inadequacy of the depletion allowance of 5 per cent made by the Act rendered the tax imposed by the 1913 Act a direct tax not on income and, hence not within the 16th Amendment. The Court disposed of this by saying it was fallacious to assume that the tax would be such a direct tax unless adequate allowance were made for depletion because:

> "Independently of the effect of the operation of the 16th Amendment, it was settled in *Stratton's Independence v. Howbert*, 231 U. S. 399, that such tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations."

Von Baumbach v. Sargent Land Company, 242 U. S. 503 (1917) is another case arising under the 1909 Excise Tax law, and involved corporations owning the fee to mining lands and receiving royalties under leases, most of which were in existence when the corporations took title to the lands. The first question presented, whether the corporations were organized for profit and "doing business," can have no application. The other questions were whether the payments received constituted "gross

income" or represented the conversion of capital into money, and, if income, whether the corporations were entitled to a depletion deduction.

In discussing the first phase of this question, while the Court referred to the holdings of the Minnesota Courts (where the property was situated) and the Courts of Pennsylvania upon the nature of mining leases, and the estates conveyed, the Court refused to base its decision upon the holding of Minnesota Courts that the payments were rents, saying that the decisive question was whether the payments were income under the 1909 Act. In holding that they were, the Court refused to distinguish, for the purposes of that case, between a lessor and owner-operator, and, upon the authority of *Stratton's Independence* and *Stanton v. Baltic Mining Company*—held such payments to be income. The depletion deduction was likewise denied. The Court recognized that equitable considerations supported the argument that such an allowance should be made, but refused to extend the "depreciation" allowance made by the Statute to cover the depletion of ore reserves.

Here, again, there is nothing touching the points we are considering. The only question which could have any application here, "whether, in considering this Federal Statute, we should be constrained to follow the established law of the State, *as is contended by the Government*, we do not need to determine."

The last of these cases, *U. S. v. Biwabik Mining Company*, 247 U. S. 116, likewise an excise tax case, dealt with a mining lessee of Minnesota property. The Com-

pany had paid a certain sum for a lease upon the property. As of January 1, 1909, it revalued the ore in place. By dividing this cost and value with estimated reserves, it arrived at two units, one of .038885 and one of .44865 per ton. In its 1910 Excise Tax return, it deducted "to cover realization of unearned increment" the sum of $265,372.08, arrived at by multiplying the sum of these two units by the quantity of ore mined in that year. The trial court upheld the company's right to deduct the amount based upon the cost of the lease, but denied the remainder. The Circuit Court reversed this and allowed the full deduction. The Supreme Court refused to follow the reasoning of the Circuit Court, saying:

> "The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of lease here involved, so long as he sees fit to hold the same without exercising the privilege of cancellation therein contained. He is, as we held in the *Sargent Land Company* case, in no legal sense a purchaser of ore in place."

The Court did not pass upon, due to the Collector's failure to take a writ of error from the trial court's decition, the correctness of the trial court's holding as to the deduction based upon cost.

This case, at the most, can only be said to hold that the lessee, like the lessor, was not entitled to deduct the value, above cost, of ore in place at the beginning of the year in arriving at net income. The State law, by which title to ore in place did not pass to a lessee, was used as an additional reason for denying the claim. That it did

not control is demonstrated by the fact that the same deduction was denied to a lessor and an operating owner, both of whom did, under applicable State law, own the ore in place.

Indeed, it supports Respondent, in that State law upon the subject of the ownership of ore as between lessee and lessor was used as at least one reason for the decision. By no effort can it be tortured into an approval of that State rule, or an announcement that, under general law, this Court would reach the same conclusion.

Work v. Mosier, 261 U. S. 352-358, cited by the Government as authority for the proposition that the cash bonus or consideration paid for the execution and delivery of the oil and gas lease is to be considered as advance royalty, was and is in no sense authority for the Government's contention in this case.

Work v. Mosier was a mandamus case filed by certain members of the Osage Tribe of Indians, under an Act of Congress June 28, 1906, as parents of certain children, to compel distribution under that Act, of money including their respective shares of bonus moneys paid the Secretary for oil leases made by the Tribal Council. The act was entitled "An Act for the Division of the Lands and Funds of the Osage Indians in Oklahoma Territory, and for other purposes." This Act provided for the enrollment of the Tribe, including minors, and for the division of the land between them by selection, the selection for the minors being made by their parents, but forbade the sale of the oil, gas, coal or other minerals covered by the lands, the minerals being reserved

to the use of the Tribe for a period of twenty-five years, the royalties to be paid to the Tribe. The Act directed that the gas and other minerals named should become the property of the individual owner of the land at the end of that period, unless otherwise provided. Section 3 of the Act directed the leasing of oil and other mineral rights in these lands by the Tribal Council under such rules and regulations as the Secretary might direct and with his approval, provided, "that the royalties to be paid to the Osage Tribe under any mineral lease so made shall be determined by the President of the United States." The opinion was written by Chief Justice Taft, who, among other things, said:

> "The questions presented are, first, the proper classification of bonuses under the statute; second, the validity of the conditions imposed by the Secretary on the payment of the minor's incomes to the parents, and third, the propriety of mandamus as a remedy in this case.
>
> "The bonus which was the result of bidding for desirable oil and gas leases secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was in effect a supplement to the royalties already determined. It was really part of the royalty or rental in a lump sum or down payment. We do not see how it can be classified as anything else. It was income from the use of the mineral resources of the land. Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the produce of the mine. What was in-

tended to be distributed to the members of the tribe was the income from the mineral deposits in their lands and the bonus was part of that. Doubtless Congress had in mind regular royalties; and did not anticipate such large down payments. But in the unexpected event we must decide under what head the bonus is to be treated, whether as capital or income, and it seems clear to us that, in view of the entire statute, it is more aptly described by the latter term."

Further in the opinion (p. 360) he expressly recognized that the bonuses were given for the mineral leases:

"He was led to take this action, which was a departure from the previous practice of the Department during the decade immediately following the passage of the act, because of the sudden increase in the income of the minors resulting from the bonuses given for mineral leases."

The opinion of the Supreme Court recognized further that the bonus moneys were distributed *merely as* royalties under said Act in the use of the following language:

"* * * including their respective shares of bonus moneys distributable as royalties under said Act."

In other words, under that particlar Act, the Court was confronted with an unexpected contingency arising under the law—the large bonuses received for the leases under competitive bids—something not contemplated by the Congress. Under this unexpected condition which had arisen, it was necessary for the Court to classify such bonuses. It is clear that these bonuses were paid as the

consideration for the execution and delivery of the leases and, in fact, had no relation to the royalties thereafter to be paid, if any, and the learned Chief Justice, when met with this contingency, was required, in solving the problem, only to ascertain from an examination of the whole Act, and all of the circumstances, whether these receipts were of the character which Congress wanted distributed currently, and to the tribe as a whole, or held for twenty-five years and distributed to individual allottees.[1]

We submit that at every point the decision in *Hirschi v. United States* either runs counter to later express pronouncements of this Court, or bases its conclusions upon matters which were not really at issue and had no bearing upon the result.

Little more can be said of the other cases dealing with the same question. *Burkett v. Commissioner of Internal Revenue*, 31 Fed. (2d) 667, by the Eighth Circuit holds that bonuses received for oil and gas leases on lands in Arkansas are not to be taxed as capital gain. There the Court said:

> "The wording and the legislative history of section 206 are clear that it was intended to apply to 'sales' in the sense of conveyance of title to property, not of the creation of privileges or estates or rights in property for a limited period of time."

When this quotation is related to the law of Arkan-

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[1]The Court's attention is directed to the treatment of *Work v. Mosier* in *Ferguson v. Commissioner of Internal Revenue*, 45 Fed. (2d) 573, 576.

sas, where the Courts apparently treat such instruments as creating a privilege, it is apparent that there is nothing in this statement which conflicts with the Respondent's position in the case at bar. The opinion contains nothing else other than a brief reference to *United States v. Biwabik Mining Company* and *Von Baumbach v. Sargent Land Company.*

Berg v. Commissioner, 33 Fed. (2d) 641, by the Court of Appeals of the District of Columbia, and likewise involving lands in Arkansas, deals with the question somewhat more fully. Again the Excise Tax and 1913 Income Tax cases, heretofore fully discussed, were cited and the opinion concluded:

> "We hold accordingly that the income of appellants under the leases in question was received as rent or royalty, and not as the purchase price of oil or gas produced from the lands by the lessees. The receipts, therefore, were not to be taxed as gains from the sale of capital assets, but as ordinary income under the Revenue Act of 1921."

In neither of these cases is the question discussed as fully as in the *Hirschi* case, nor are any new reasons advanced in either for the holdings there made, and it is important to note that each follows the law of the State as to the effect of an oil and gas lease.

In earlier proceedings, the case of *Alexander v. King* has been cited. This is by the Tenth Circuit Court and is reported in 46 Fed. (2d) 235. The question there presented was whether or not the proceeds derived from month to month by a lessor from the retained royalties

in an oil and gas lease on lands in Oklahoma were capital gains. There the Court expressly recognized the principle upon which our position is based. It was there said (p. 238):

> "The petitions allege that the income arose from 'the sale of oil and gas produced' which had been owned by them for more than two years. Plaintiffs did own the land, or mineral rights therein, for more than two years; but did they own the oil thereunder until it was reduced to possession which was within two years? The answer must be found in the decisions of the Supreme Court of California. *Poe v. Seaborn*, 282 U. S. 101; *Crooks v. Harrelson*, 282 U. S. 55."

The Court then went on to point out that under the decisions of Oklahoma:

> "the plaintiffs did not own the oil before it was reduced to possession; their ownership of the soil arose within the two-year limitation of the Statute, and they are not entitled to exercise the election afforded by Section 206 of the Revenue Act of 1921 or by Section 208 of the 1924 and 1926 Acts."

In no case, we submit, has it been more clearly recognized that the answer to the question must be found in State law.

Two other cases frequently cited may well be discussed together. One is the case of *Rosenberger v. McCaughn*, 25 Fed. (2d) 699, decided by the Third Circuit, and *Bankers' Pocahontas Coal Company v. Commissioner*, 55 Fed. (2d) 626, decided by the Fourth Circuit.

In the first case the taxpayer had inherited an in-

terest in a tract of land in Pennsylvania, which had, in 1881, been leased for coal and from which, in 1917 and 1918, substantial royalties were received. She refused to return any part of these sums for taxation and the Commissioner of Internal Revenue then required her to pay taxes upon the net income received by her. This was represented by

> "The difference between the total amount she received and the capital value as of March 1, 1913, according to the rule for determining income from mining laid down in *New Creek Co. v. Lederer*, 295 Fed. 433."

She took the position that because, under the law of Pennsylvania, the coal lease made by her ancestor constituted a sale of the minerals in place, she was, by virtue of her inheritance, only collecting deferred payments on the purchase price, which were not income. This position was, of course, denied. The Court injected into the case the question of the effect of State rules of property, but finally reached the conclusion that:

> "We think each payment represented in some measure both capital and increment, capital because it stood in the place of coal and increment because in the payments running through ninety-nine years interest on the capital must inevitably have been included, and that this increment or interest was a gain 'derived' within the generalization of the statute 'from any source whatever' and was income in substantially the sense of *New Creek Company v. Lederer*, 295 Fed. 433. The plaintiff can very properly demand that the capital included in her proceeds from mining shall not be taxed. *U. S. v. Ludey*, 274

U. S. 295. But when the capital in the proceeds has been determined and set aside the balance is income and the very thing on which the Government lays its hand and exacts a tax."

Substantially the same situation is revealed in the *Bankers' Pocahontas Coal Company* case. That corporation was the fee owner of lands in West Virginia, which had been leased long before it acquired the land in 1912 for coal. Its contention was that:

> "These contracts, executed in the years 1901 and 1902, and acquired by it in the year 1912, were sales of coal in place that were fully complete before the 16th Amendment went into effect, and that the royalties received during the period 1922 to 1926 were merely payments of obligations that existed unconditionally on March 1, 1913, and were not income taxable under the Federal Revenue Acts."

This contention was, of course, based upon the proposition that under the law of West Virginia the leases constituted sales of the coal in place. The Court referred to *Rosenberger v. McCaughn*, supra, to State Rules of Property and many other cases, including the Excise Tax and 1913 Income Tax cases heretofore discussed. It appears that the taxpayer took the position that *Crooks v. Harrelson*, *Poe v. Seaborn* and *Tyler v. United States* represented a reversal of this Court's previous position in *Weiss v. Weiner*, and the other cases referred to, as to the effect of State law upon Federal tax questions, and in dealing with this contention, the Court said:

> "But it is obvious that each of these decisions turned upon the fundamental question whether the

> property sought to be taxed came within the purview of the taxing statutes. When it was clear that such was the case, the federal statute was given effect; as in *Tyler v. U. S.*, 281 U. S. 497. * * * In the other cited cases, on the other hand, property was held to be excluded from the tax proposed because it did not come within the terms of the statute, and this conclusion was maintained although it was occasioned by observance of a state rule of property, and it was clear that the ruling would bring about a lack of uniformity in the incidence and operation of the tax in different states by reason of diversity of local property rules. The Supreme Court has never abandoned the rule as to the effect of state decisions on questions of property; but it has held in some instances that state decisions do not cover the whole ground to which the federal taxing statutes relate, and, in other instances, that the statutes or decisions of the state lay down rules which define and limit the property which Congress has undertaken to tax."

And the Court upheld a tax on the difference between the royalties received and their March 1, 1913, value.

It may be fairly said, it is submitted, with respect to these last two cases, that, basically, they do not involve the question with which we are concerned, and that in each case the Court went out of its way to surmount difficulties which did not exist. We submit that, in each of these cases, it did not make the slightest difference in the result whether the leases were considered sales of ore in place, grants of privilege or anything else. In practical effect, each taxpayer was, on March 1, 1913, entitled to receive, over a long period of time, periodic non-interest bearing payments—the exact amount of which could not

be definitely ascertained. And it is equally apparent that whether this right had arisen from an absolute sale of the entire fee, or from a rental contract, or from any other source, there was a substantial value on March 1, 1913, in this right to receive payments, but this substantial value was much less than the ultimate receipts over the period of years, for the simple reason that no deferred obligation, which is non-interest bearing, can be worth it face value or the amount ultimately received in later years. Therefore, when each royalty payment was received, subsequent to 1913, there was an element of interest or enhancement in each payment and likewise an element of capital representing the March 1, 1913, value. The March 1, 1913, value, under the Statute, and perhaps under the Constitution, was to be returned tax free, and this was done, and the remainder was to be taxed as income. It is obvious, we submit, that the result would have been the same, regardless of State law, and that the discussion of that question was unnecessarily injected into these cases.

The true situation, we submit, is practically parallel with that dealt with by this Court in *Burnet v. Logan*, 283 U. S. 404, where a taxpayer, who had inherited shares of stock in a corporation in 1917, was held entitled to apply all of the proceeds derived from the sale of the stock (the sale price being fixed in part by a certain sum per ton of ore mined from minerals in which the corporation had an interest) until there was restored to her her capital investment in the property. Cf *Burnet v. Houston*, 283 U. S. 223.

That the Fourth Circuit did not intend, in the *Bank-*

ers' Pocahontas Coal Company case, to announce a rule different from that here urged, but considered the question there presented a different one, is clearly shown by its opinon in *Leser v. Burnet*, 46 Fed. (2d) 756. The question there presented was whether a power of appointment was a general or special power. If the power was general, the property subject to the power situated in Maryland was to be included in the gross estate of the decedent exercising the power; if special, it was not to be so included. The language used in creating the power would have created, in most jurisdictions, a general power, in that it would have conferred authority to appoint the property in favor of the donee's own creditors, but in Maryland the rule was different and it required there additional language to confer this power and create thereby a general power. The Court said upon this point (p. 760):

> "We come, then, to the question as to whether the power created by the conveyance of Charles Carroll Fulton, the language of which we have quoted above, is a general power within this meaning of the act of Congress. This is to be determined by the law of Maryland; for, while we look to the federal decisions, and in the absence of such decisions, to the general law, in interpreting the act of Congress, we look to the law of Maryland as laid down by its courts to determine the effect of conveyances executed within that state and relating to property there situate. *Tyler v. U. S.*, 281 U. S. 497; *Warburton v. White*, 176 U. S. 484. And under the law of Maryland it seems to be well settled that language such as that contained in the Fulton conveyance does not confer upon the donee of the power the right to exer-

cise same in favor of his own creditors. The language used in that conveyance, it is true, is such as in most jurisdictions would be held to create a general power with right in the donee to exercise it in favor of his creditors; *but we are concerned, not with what meaning and effect would be given that language generally, but with what meaning and effect is given it by the Maryland law as laid down by the courts of that state.* Under their decisions, the language used creates, not a general power, but one limited to the extent that it may not be exercised by the donee for his own benefit or for the benefit of his estate or of his creditors. In other words, it creates a mere naked power from which neither the donee nor the creditors of his estate can profit."

We may safely assume that this Court did not, when it decided the *Bankers' Pocahontas Coal Company* case a few months later, intend to depart from the rule so clearly and accurately expressed in the quotation above set forth, for it neither cited nor in any other way referred to its previous decision, and made no attempt to distinguish between the *Leser* case and that.

Tyler v. U. S., 281 U. S. 497, is not, it is submitted, an authority for Petitioner. On the contrary it, with *Burk-Waggoner v. Hopkins*, supra, furnishes an excellent illustration of a principle contended for by the Respondent—the distinction between the tests to be used to determine what Congress can do, and to determine the altogether different question of what Congress has done.

The *Tyler* case dealt solely with the constitutionality of that portion of the Revenue Act of 1916 (Sec. 202 (c)) which required the inclusion, in the net estate of a dece-

dent subject to the Estate Tax, of all property held by the decedent and another "as tenants in the entirety" as was not shown to have belonged originally to the other person and never to the decedent. The express intent of Congress to measure the tax in that way was recognized, and the Court proceeded to deal with "power" instead of "intention."

Referring to the decisions of Pennsylvania and Maryland, where the property was situated, as to the nature of the estate, the Court recognized that such decisions established "a state rule of property, by which, of course, this Court is bound. *Warburton v. White*, 176, U. S. 484, 496." The Court then examined the real basis of the tax, found that death was the "generating source" from which the authority to impose the tax took its being, and the question was not whether there had been, strictly, a "transfer" but whether death had "ripened for the survivor, property rights of such a character as to make appropriate the imposition of a tax upon the result." It is clearly inferable from the opinion that, had the question been whether a "transfer" had been made, the holdings of the state courts would have concluded the matter. And, to determine whether rights had been ripened by death, the Court examined the rights and privileges which the surviving wife had before and after her spouse's death—which rights were fixed and determined by, and could only be ascertained from, state law—and finding that the death of one spouse increased the rights and privileges of the survivor to an extent warranting the tax, upheld it.

The Court in this case did not think, we venture to

assert, that it was limiting the Federal Taxing power when it recognized that State rules of property were binding everywhere, and when it looked to the actualities as disclosed by State rules, to determine, in measuring the power of Congress to make the challenged levy, whether substantial rights had been generated by death.

This case, we again urge, illustrates the correct doctrine. The State law furnished the answer to such questions as to what rights and titles the spouses had in the property before the death of one and what rights and titles accrued to the survivor. This Court accepted the answer so found, and then reached its own independent determination as to whether these were sufficient to support the levy. If any other method had been followed, it is clear that a tax might have been collected upon the determination by this Court that the surviving spouse had certain rights and, when, after paying the tax, she returned to the state where the property was located, and attempted to exercise those rights, she would find that the State Court, the final arbiter on the question, refused to allow her those rights.

Again, we point out that our question is narrower, that Congress has related the capital gain question to state property rules, and that this Court has expressly adopted, in the *Group No. 1* case[1] the precise rule here invoked for deciding a Federal tax case.

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[1]The Petitioner quotes from the Government's brief in the *Group No. 1* case (footnote 15, p. 27, Government's brief in this case): "On the other hand, however, where the point in controversy relates to property rights as between two contracting parties, the rule of the local court

CONCLUSION

We submit that the Fifth Circuit Court correctly disposed of the whole question in its opinion in the *Ferguson* case, 45 Fed. (2d) 573, when it said that:

> "Congress could, if it saw fit, declare what was meant (by the word 'sale') and the Federal Courts are not bound by the decisions of the state on questions of general law. But the word 'sale' seems to have the same meaning wherever used, and, as to the interest or title which was conveyed by the transfers, we think reliance must be had upon the law of Texas."

When to this is added the observations made by the same Court in this case (R. 20-21) that this Court has held that "an oil and gas lease constitutes a present sale of the oil and gas in place, under the Constitution and laws of Texas," referring to the *Group No. 1* case, and that "It is no new doctrine that a rule of property prevailing in a state, and changes in that rule, will be rec-

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will be followed in the Federal Courts." In this case the two contracting parties are Respondent and his so-called lessees. The controversial point is whether by the contract property right passed and, if so, what those rights were. We submit that here, again, is a concession of the very point upon which we rely.

ognized in administering the Federal Income Tax law"; the contentions of the Petitioner are effectively answered.

We respectfully submit that the judgment of the Court below should, therefore, be affirmed.

Respectfully submitted,

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APPENDIX

Excerpts from Regulations 65 relating to income tax under the Revenue Act of 1924:

"Art. 201. DEPLETION OF MINES, OIL AND GAS WELLS; DEPRECIATION OF IMPROVEMENTS.—Sections 214 (a) (9) and 234 (a) (8) provide that tax payers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See Section 204 (c) and Article 1602 with reference to the basis for computing depreciation and depletion.

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) the cost of his property, or (b) the value of his property on the basic date plus, in either case, subsequent allowable capital additions (see Article 224), but not including land value for purposes other than the extractions of minerals. See Section 204 (c) and Article 1602.

"Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a mining or oil or gas corporation is not allowed such deductions.

"When used in these articles (201-239) covering depletion and depreciation—

"(a) The term 'basic date' indicates the date of valuation, i. e., March 1, 1913, in the case of property

acquired prior thereto, if the cost was less than the fair market value on March 1, 1913; the date of acquisition in the case of property acquired on or after March 1, 1913, or in the case of property acquired before March 1, 1913, if the cost of such property was greater than its fair market value on March 1, 1913; or the date of discovery, or a date within 30 days thereafter, in the case of discovery."

* * *

"Art. 203. AMOUNT RETURNABLE THROUGH DEPLETION AND DEDUCTIONS IN CASE OF LESSEE.—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

"(2) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

"(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is (1) its cost or (2) the value of his interest in the mineral as of that date, whichever is greater.

"(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

"(e) The value of a lessee's equity in a discovery after February 28, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered.

Art. 216. DEPLETION—ADJUSTMENTS OF ACCOUNTS BASED ON BONUS OR ADVANCED ROYALTY.—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition. * * *"

Treasury Decision 3938 (Cumulative Bulletin V-2):

"TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
WASHINGTON, D. C.

"*To Collectors of Internal Revenue and Others Concerned:*

"Article 215 of Regulations 45 (1920 edition), Article 215 of Regulations 62, and Article 216 of Regulations 65 are hereby amended to read as follows:

"Art. 216 (215). *Depletion — Adjustment of Accounts on Bonus or Advanced Royalty.* — (a) Where a lessor receives a bonus in addition to royalties, there shall be allowed a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received. * * *

"All rulings inconsistent herewith are hereby revoked.

D. H. BLAIR,
Commissioner of Internal Revenue.

"Approved November 13, 1926.
A. W. MELLON,
Secretary of the Treasury."

Regulations 71, revised July, 1932, relating to stamp taxes under the Revenue Act of 1932:

"Art. 84. *What Constitutes Real Property Determined by Law of State Where Located.*—(a) What constitutes 'lands, tenements, or other realty' is determined by the law of the State in which the property is situated. Standing timber is ordinarily held to be real estate, and where so held the deed transferring it is subject to the tax.

"(b) In states where common-law dower still exists an instrument purporting to convey the inchoate right of dower of a wife or the consummate right of

dower of a widow, prior to assignment of dower, is not subject to stamp tax; but an instrument conveying the estate acquired by a widow upon assignment of dower is subject to tax. Where by statute dower has been abolished and a different interest in the husband's real property conferred upon the wife in lieu thereof, the taxability of an instrument purporting to convey such an interest prior to its assignment will be determined by the nature of the wife's interest, and the statutes and decisions of the particular State in which the real estate is located must be consulted."

The regulations adopted to enforce similar provisions of the Revenue Acts of 1918, 1921 and 1924 were identical.

RULING OF TREASURY DEPARTMENT UNDER THE STAMP TAX PROVISIONS OF THE REVENUE ACT OF 1932—holding that oil and gas leases on Texas lands, and assignments thereof, are subject to stamp tax:

"TREASURY DEPARTMENT
WASHINGTON
Aug. 12, 1932

Office of
Commissioner of Internal Revenue

MT:ST:WLM

Mr. A. H. Britain,
Wichita Falls, Texas.

Sir:

Receipt is acknowledged of your letter of July

12, 1932, concerning the taxability of an oil and gas lease styled 'Producers 88 Special Form Texas Lease' under Section 725 of the Revenue Act of 1932.

"You are advised that Section 725 imposes a tax on any instrument whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to a purchaser or purchasers. That which constitutes lands, tenements, or other realty is determinable by the laws of the State in which the property is situated.

"The instrument submitted by you provides that the party of the first part, called the lessor, does 'grant, demise, lease, and let unto' the party of the second part, called the lessee, certain land 'for the sole and only purpose of mining and operating for oil and gas, and laying pipe lines, and building tanks, powers, stations, and structures thereon to produce, save, and take care of said products.' It is agreed that the lease shall remain in force for a term of three years from its date, and as long thereafter as oil or gas, or either of them is produced from the land by the lessee.

"In Liberty Central Trust Co. v. Gilliland Oil Co., the District Court of the United States, Northern District of Texas, held that the interest of a lessee under an oil and gas lease was subject to assessment for State and county taxes. In reaching this opinion the Court said: 'That the lease is a conveyance of the land as well as the right to use it for an undeterminable period of time; the lessee by reason of the instrument has exclusive dominion over the oil and gas therein found and this dominion and ownership is as effective as though the oil were described in

gallons, texture, fineness, and color, and the gas in cubic feet and volatility.'

"In view of the above facts it is held that the instrument submitted by you constitutes an interest in real property and is therefore subject to the tax imposed by Section 725 of the Revenue Act of 1932. The assignment of such lease conveying the same interest, which is created by the lease, is also a conveyance of an interest in realty and subject to the tax under the same provisions of the Act.

Respectfully,

(Signed) R. M. ESTES,
Deputy Commissioner.

"MBC:RL
cc-Dallas, Texas."

FILE COPY

Office Supreme Court
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CHARLES ELMORE

IN THE

Supreme Court of the United States

October Term, 1931

No. 26

DAVID BURNET,
COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

HENRY HARMEL

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Motion of Walter E. Barton for Leave to File Brief as Amicus Curiae in Opposition, and Brief of Amicus Curiae in Opposition.

WALTER E. BARTON,
Investment Building,
Washington, D. C.
Counsel for W. T. Waggoner and Ella Waggoner, as Amicus Curiae.

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IN THE

Supreme Court of the United States

October Term, 1931

No. 824

DAVID BURNET,
COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

VS.

HENRY HARMEL

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Motion for Leave to File Brief as Amicus Curiae in Opposition.

May it please the Court:

The undersigned, as counsel for *W. T. Waggoner and Ella Waggoner,* respectfully moves this Honorable Court for leave to file the accompanying brief in this case as *amicus curiae* in opposition.

WALTER E. BARTON,
Investment Building,
Washington, D. C.
Counsel for W. T. Waggoner and Ella Waggoner, as Amicus Curiae.

IN THE

Supreme Court of the United States

October Term, 1931

No. 824

DAVID BURNET,
COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

VS.

HENRY HARMEL

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Brief of Walter E. Barton as Amicus Curiae in Opposition.

PRELIMINARY

W. T. Waggoner and Ella Waggoner filed appeals from the Commissioner of Internal Revenue to the United States Board of Tax Appeals, raising the question of whether cash considerations received by them in 1922 for the execution of certain instruments, commonly known as "oil and gas leases," on lands owned by them in Texas, which, under the law of Texas,

actually conveyed title to the oil and gas in place to the lessee, were taxable as capital gain within the purview of Section 206 of the Revenue Act of 1921. The Board of Tax Appeals held that such cash considerations were taxable as capital gain and not as ordinary income. (*W. T. Waggoner et al.*, 24 B. T. A. 657.) In deciding thus, the Board of Tax Appeals followed *Ferguson* v. *Commissioner*, 45 Fed. (2d) 573, and reversed its own previous decisions in *Ferguson* v. *Commissioner*, 20 B. T. A. 130, and *Harmel* v. *Commissioner*, 19 B. T. A. 376. Since the Board decided the *Waggoner* case, the Circuit Court of Appeals for the Fifth Circuit reversed the Board in the *Harmel* case, which judgment this Court is now requested by the petitioner herein to review. (R. 35.)

The same question that is raised in the instant case is presented in *W. T. Waggoner et al.* v. *Commissioner*, *supra*, and the decision of this court in the former will determine the issue in the latter.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Statement

The taxpayer is an individual residing at Megargel, Texas. In the year 1924 the taxpayer was, and had been for many years, the owner in fee simple of certain lands. In October, 1924, he executed two instruments, commonly known as "oil and gas leases," covering said land, on the basis of stipulated royalties and a cash consideration of $57,000.00. (R. 15.) This cash consideration was returned by taxpayer as gain from the sale of capital assets under Section 208, Revenue Act of 1924. The Commissioner of Internal Revenue

treated it as income taxable at the ordinary rates. (R. 9.) The Board of Tax Appeals held with the Commissioner (R. 18), and the Circuit Court of Appeals for the Fifth Circuit reversed the Board. (R. 35.)

The two oil leases referred to above are set out in full in the record. (R. 25-34.)

Question Presented

Whether a cash consideration received by the owner of lands situated in Texas, for the execution of an instrument commonly known as an "oil and gas lease," which, under the law of Texas, actually conveys title to the oil and gas in place to the lessee, is taxable as capital gain under Section 208 of the Revenue Act of 1924?

The findings of the Board of Tax Appeals were that the taxpayer received "stipulated royalties and a cash consideration of $57,000.00." (R. 15.) The opinion of the Board (R. 16) and the opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 35) refer to the $57,000.00 received as "cash consideration" and not as "advance royalties."

Statute Involved

The statute involved is Section 208 of the Revenue Act of 1924, which is printed in full in petitioner's petition beginning on page 2.

Reasons for Denying the Writ

1. Congress did not qualify the word "sale," and, hence, it was used in its ordinary sense. (*U. S.* v. *Merriam,* 263 U. S. 179.) If the instruments given by the taxpayer passed title to the oil and gas in place to the lessee, a sale was consummated, as this is the essence of a sale. (23 *R. C. L.* 1186; 55 *C. J.* 36.)

2. It is the settled law of the State of Texas that

such instruments convey title to the oil and gas in place to the lessee. (*Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279; *Theisin* v. *Robison,* 117 Tex. 489, 502, 8 S. W. (2d) 646; *Texas Co.* v. *Daugherty,* 107 Tex. 226, 176 S. W. 717; *Stephens Co.* v. *Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 254 S. W. 290, cf. *W. T. Waggoner Est.* v. *Wichita Co.,* 273 U. S. 113.) Hence a sale was consummated by the taxpayer on the execution and delivery of the instruments in question.

3. The federal courts will follow state laws with respect to the title to property. (25 *C. J.* 839; 27 *R. C. L.* 51; 28 *U. S. C. A.,* annotation 143; *Guffey* v. *Smith,* 237 U. S. 112, 115; *Poe* v. *Seaborn,* 282 U. S. 101; *U. S.* v. *Robbins,* 269 U. S. 315; *U. S.* v. *Malcolm,* 282 U. S. 792; *Crooks* v. *Harrelson,* 282 U. S. 55; *U. S.* v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55.)

In *Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279, this Court held that under the decisions of the highest court of Texas, instruments, such as the ones involved in the instant case, conveyed title to the oil and gas in place to the lessee, and that such decisions were binding upon Federal Courts as a rule of local law defining property rights. This was the contention of the government in that case (Government's brief, p. 5); but now this Court is asked to disregard the law of Texas regarding vested property rights.

4. A number of cases are cited by petitioner to support his position, but in our opinion they do not do so.

In *Work* v. *Mosier,* 261 U. S. 352, the question was whether under the Act of Congress of June 28, 1906, cash bonuses received on the execution of oil and gas leases of Osage Indian lands should be classed as capital or income. If capital, the bonuses were to be held by the Secretary of the Interior; and if income, they were to be paid over to the Indians. This Court held

that the question of whether bonuses were to be included in royalties was a matter of statutory construction, and that in view of the entire statute involved, bonuses were more aptly described as income than as capital. Not only were the lands situated in Oklahoma, where the law of the state is that oil and gas leases do not convey title to oil and gas in place to the lessee (*Rich* v. *Doneghey,* 71 Okla. 204, 177 Pac. 86); but the Act of June 28, 1906, specifically provided that title to the oil and gas in place should not vest in the Indians for twenty-five years, and that the oil and gas in place could not be sold.

In *Strattons' Independence* v. *Howbert,* 231 U. S. 399, this Court held that mining corporations extracting ores from their own premises were subject to the Excise Tax Act of 1909; that the proceeds from the sale of such ores were income; and that the difference between the selling price of the ores and the cost of removing the same was not deductible as *depreciation* under said Act. In *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, it was held that royalties received by a corporation lessor of Minnesota lands represented income under the Excise Tax Act of 1909 and not the conversion of investment from ore into money, following *Strattons' Independence* v. *Howbert, supra,* and that the taxpayer was not permitted to deduct the value of the extracted ore in place as *depreciation.* In *U. S.* v. *Biwabik Mining Co.,* 247 U. S. 116, it was held that the proceeds of iron ore mined by a corporate lessee of Minnesota lands were income under the Excise Tax Act of 1909, and that the taxpayer could not deduct as capital invested the fair market value of the ore in place as of January 1, 1909. It was held that under Minnesota law a lessee was not a purchaser of the ore in place, and that the Court had pointed out this fact in *Von Baumbach* v. *Sargent Land Co., supra.* In

Stanton v. *Baltic Mining Co.*, 240 U. S. 103, 114, this Court rejected the taxpayer's contention that the Revenue Act of 1913 was unconstitutional as an unapportioned direct tax when applied to mining corporations because the 5 per cent allowance for depletion was inadequate. It was not held by the Court below in the instant case that the cash considerations did not represent income, but merely that the *source* of the cash considerations was from the sale of the oil and gas in place.

The decision below is not in conflict with *Burkett* v. *Commissioner*, 31 Fed. (2d) 667; *Berg* v. *Commissioner*, 33 Fed. (2d) 641; *Murphy* v. *Commissioner*, 9 B. T. A. 610; *Reynolds* v. *Commissioner*, 10 B. T. A. 651; all of which involved oil and gas leases of lands situated in Arkansas, nor with *Alexander* v. *King*, 46 Fed. (2d) 235, which involved an oil and gas lease in Oklahoma, where the law of the respective states is that such an instrument does not pass title to the oil and gas in place to the lessee. (*Osborn* v. *Arkansas Ter. Oil & Gas Co.*, 103 Ark. 175; *Rich* v. *Doneghey*, 71 Okla. 204, 177 Pac. 86, 89.) In deciding *Alexander* v. *King*, *supra*, the Circuit Court of Appeals for the Eighth Circuit not only held that it was necessary to look to the Oklahoma law to see whether title to the oil and gas had passed to the lessee, but clearly distinguished its decision from *Ferguson* v. *Commissioner*, *supra*, by pointing out the difference between the laws of Texas and Oklahoma on this question.

The statutes involved in the cases of *U. S.* v. *Cambridge Loan & Bldg. Co.*, 278 U. S. 55, and *Crooks* v. *Harrelson*, 282 U. S. 55, did not indicate that Congress intended that local state laws should govern the classification. The terms used were general, and this Court held that the respective state laws were determinative of the questions. In *Burk Waggoner Oil Assn.* v. *Hop-*

kins, 269 U. S. 110, this Court held that the term "association" as used in the Act comprehended partnerships similar to the one involved in that case, and that the local law of the state was without legal significance as bearing upon the *power* of Congress to determine how and at what rate the income of a joint enterprise should be taxed. In the instant case the term "sale" is not defined in the Act, and the only question presented is one of construction and not one of power. In *Weiss* v. *Weiner,* 279 U. S. 333, the question was whether a lessee of a long term lease acquired after March 1, 1913, could take a deduction for depreciation of buildings, where he did not pay anything for the lease except an annual rental and did not pay for the buildings on the leased premises. This Court held that he could not, and that it was immaterial that under the Ohio law, where the properties were located, such a lease was treated in many respects as a conveyance of the fee. There was no capital invested, and, hence, no allowable deduction.

In *Rosenberger* v. *McCaughn,* 25 Fed. (2d) 699, the lessor of Pennsylvania lands gave a lease long prior to March 1, 1913, reserving monthly rentals. The Court recognized that under the Pennsylvania law the lease conveyed title to the coal in place to the lessee, and held that a part of the payment represented capital and a part income, but inasmuch as the taxpayer merely contended that the *entire* payments were capital and not income, the findings of the Commissioner of Internal Revenue were not disturbed. In *Pocahontas Coal Co.* v. *Commissioner,* 55 Fed. (2d) 626, coal leases of West Virginia lands made prior to March 1,1913, were involved. The Court recognized that under the West Virginia law such leases conveyed title to the coal in place to the lessee, but rejected the taxpayer's contention that the *entire* royalties received from 1920 to 1926

represented capital. No alternative contention was made that the present worth of the royalties on March 1, 1913, represented capital, but merely that the depletion allowance was inadequate. These cases would be applicable to the instant case if the taxpayer had made the leases in question prior to March 1, 1913, with cash consideration deferred until 1924, and then contended that the entire cash consideration was capital in the year in which received.

5. The only case cited by petitioner, which in our opinion is in conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in the instant case, is *Hirschi* v. *U. S.*, 67 Ct. Cl. 637. The Court of Claims held that Texas law did not govern in determining whether a sale of the oil and gas in place had been made, citing *Steedman* v. *U. S.*, 63 Ct. Cl. 226. The latter case involved the identical question as *Crooks* v. *Harrelson, supra,* and was overruled by this Court in the latter case. Furthermore, since the *Hirschi* case was decided, this Court, in *Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279, sustained the Circuit Court of Appeals for the Fifth Circuit (41 Fed. (2d) 483), and held that under the law of Texas an instrument similar to the ones involved herein conveyed title to the oil and gas in place to the lessee, and that the law of that state was controlling as to the *source* of the income of the lessee. That decision necessarily settled the rule that the granting of an instrument, customarily known as an "oil and gas lease," in Texas constitutes a sale of the oil and gas in place to the lessee, and that the Texas law is binding upon Federal Courts in connection with Federal income tax questions. (*Guffey* v. *Smith,* 237 U. S. 101.)

CONCLUSION

The decision of the Circuit Court of Appeals for the Fifth Circuit was correct and the case does not present

questions justifying the consideration of this Court on writ of certiorari.

Respectfully submitted,

WALTER E. BARTON,
Investment Building,
Washington, D. C.
Counsel for W. T. Waggoner and Ella Waggoner, as Amicus Curiae.

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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

No. 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF WALTER E. BARTON AS AMICUS CURIAE

WALTER E. BARTON,
Investment Bldg., Washington, D. C.
Counsel for W. T. Waggoner and Ella Waggoner, as Amicus Curiae.

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27 Ruling Case Law 51 ..... 8, 18
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6 Words & Phrases (3rd Ser.) 907 17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

No. 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

May it please the Court:

The undersigned, as counsel for *W. T. Waggoner* and *Ella Waggoner,* respectfully moves this Honorable Court for leave to file the accompanying brief in this case as *amicus curiae.*

WALTER E. BARTON,
Investment Bldg., Washington, D. C.
Counsel for W. T. Waggoner and Ella Waggoner, as Amicus Curiae.

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BRIEF OF WALTER E. BARTON AS AMICUS CURIAE

PRELIMINARY

W. T. Waggoner and Ella Waggoner filed appeals from the Commissioner of Internal Revenue to the United States Board of Tax Appeals, raising the question of whether cash considerations received by them in 1922 for the execution of certain instruments, commonly known as "oil and gas leases," on lands owned by them in Texas, which, under the law of Texas, actually conveyed title to the oil and gas in place to the lessee, were taxable gain within the purview of Section 206 of the

Revenue Act of 1921. The Board of Tax Appeals held that such cash considerations were taxable as capital gain and not as ordinary income. (*W. T. Waggoner et al.,* Docket Nos. 33516, 33517, 24 B. T. A. 657.) The Commissioner of Internal Revenue has filed with the Board of Tax Appeals a petition to the United States Circuit Court of Appeals for the Fifth Circuit for review of the order of the United States Board of Tax Appeals, which petition for review has not yet been docketed in the Circuit Court of Appeals for the Fifth Circuit.

The same question that is raised in the instant case is presented in *W. T. Waggoner et al., supra,* and the decision of this Court in the former will determine the issue in the latter.

We shall attempt to show that the judgment of the court below in the instant case should be affirmed.

Opinions Below

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 20) is reported in 56 F. (2d) 153. The opinion of the Board of Tax Appeals (R. 8-10) is reported in 19 B. T. A. 376.

Jurisdiction

The judgment of the Circuit Court of Appeals for the Fifth Circuit was entered February 23, 1932. (R. 21.) Petition for a writ of certiorari was granted April 18, 1932. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented

The petitioner states the question to be whether *cash bonuses paid as advance royalties* under oil and gas leases on lands in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924. (Petitioner's brief, p. 2.)

The findings of the Board of Tax Appeals were that the respondent received "stipulated royalties and a cash consideration of $57,000.00." (R. 8.) The opinion of the Board (R. 9) and the opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 20) refer to the $57,000.00 received as "cash consideration" and not as "advance royalties."

It is respectfully represented that the question presented is:

Whether a cash consideration received by the owner of lands situated in Texas, for the execution of an instrument commonly known as an "oil and gas lease," which, under the law of Texas, actually conveys title to the oil and gas in place to the lessee, is taxable as capital gain under Section 208 of the Revenue Act of 1924?

Statute Involved

Revenue Act of 1924, c. 234, 43 Stat. 253, 162:

> Sec. 208 (a) For the purposes of this title—
>
> (1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;
>
> (2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets;

(3) The term "capital deductions" means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;

(4) The term "ordinary deductions" means the deductions allowed by section 214 other than capital losses and capital deductions;

(5) The term "capital net gain" means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term "capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain;

(7) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term "capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain.

* * * * * *

(U. S. C., Title 26, Sec. 939.)

STATEMENT

The respondent is an individual residing at Megargel, Texas. (R. 8.) In the year 1924 the respondent was, and had been for many years, the owner in fee simple of certain land in Texas. (R. 8.) In October, 1924, he executed two instruments, commonly known as "oil and gas leases," covering said land, on the basis of stipulated royalties and a cash consideration of $57,000.00. (R. 8.) This cash consideration was returned by respondent as gain from the sale of capital assets under Section 208, Revenue Act of 1924. (R. 9.) The Commissioner of Internal Revenue treated it as income taxable at the ordinary rates. (R. 9.) The Board of Tax Appeals held with the Commissioner (R. 9.), and the Circuit Court of Appeals for the Fifth Circuit reversed the Board. (R. 20.)

The two oil leases referred to above are set out in full in the record. (R. 14-19.)

SUMMARY OF ARGUMENT

1. The question presented is whether a *sale* of capital assets was consummated. Congress did not qualify the word "sale," and, hence, it was used in its ordinary sense. (*U. S. v. Merriam,* 263 U. S. 179.) If the instruments given by the respondent passed title to the oil and gas in place to the lessee, a sale was consummated, as this is the essence of a sale. (23 *R. C. L.* 1186; 55 *C. J.* 36.)

2. It is the settled law of the State of Texas that such instruments convey title to the oil and gas in place to the lessee, which is a *sale* as contemplated by the Act. (*Group No. 1 Oil Corp. v. Bass,* 283 U. S. 279; *Theisin v. Robison,* 117 *Tex.* 489, 502 S. W. (2d) 646; *Texas Co. v. Daugherty,* 107 Tex. 226, 176 S. W. 717; *Stephens Co. v. Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 154 S. W. 290, cf. *W. T. Waggoner Est. v. Wichita Co.,* 273 U. S. 113.) Hence a sale was consummated by the taxpayer on the execution and delivery of the instruments in question.

3. The federal courts will follow state laws with respect to the title to property. (25 *C. J.* 839; 27 *R. C. L.* 51; 28 *U. S. C. A.,* annotation 143; *Guffey v. Smith,* 237 U. S. 112, 113; *Poe v. Seaborn,* 282 U. S. 101; *U. S. v. Robbins,* 269 U. S. 315; *U. S. v. Malcolm,* 282 U. S. 792; *Crooks v. Harelson,* 282 U. S. 55; U. S. v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55.)

Work v. Mosier, 261 U. S. 232, chiefly relied upon by petitioner to sustain his argument that bonuses received for the execution of oil and gas leases represent ordinary royalties, is not in point.

The construction of the Act of June 28, 1906, pertaining to Osage Indian lands, and not a Revenue Act, was involved. The question was whether unanticipated bonuses received on the execution of oil and gas leases on these Indian lands should be paid over to the Indians quarterly as "royalties," or kept on deposit in the Treasury of the United States with other Indian monies for a number of years, and only the interest thereon paid over to the Indians. This Court held that it was a matter of statutory construction; and that plain intendment of the Act was that such bonuses were to be paid over quarterly as "royalties."

Cases arising under the Excise Tax Act of 1909 do not help. (*U. S. v. Biwabik Min. Co.*, 147 U. S. 116; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503; *Strattons' Ind. v. Howbert*, 231 U. S. 399.) They involved the construction of that particular Act, which was an excise tax and not an income tax act.

Stanton v. Baltic Min. Co., 240 U. S. 103, 114, involved the constitutionality of the Revenue Act of 1913, and is not pertinent here.

The question at issue is governed by the decisions of this Court in *Group No. 1 Oil Corp. v. Bass, supra,* and *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393. Every case, except one, relied upon by the petitioner, involving the question of whether bonuses from oil and gas leases represent proceeds from the sale of capital assets or ordinary royalties, arose in states where it is the settled law that such leases do not pass title to the oil and gas in place to the lessee. The exception is *Hirschi v.*

U. S., 67 Ct. Cl. 637, and the opinion in that case was written before this Court decided *Group No. 1 Oil Corp. v. Bass, supra,* and *Burnet v. Coronado Oil & Gas Co.*

The cash consideration was received by the respondent from the sale of capital assets, and the judgment of the Court below should be affirmed.

ARGUMENT

I

The Cash Consideration Received by the Respondent Was Not a Royalty

The petitioner argues that the cash consideration received by the respondent on the execution of the oil and gas leases in question represented advance royalties, relying chiefly on *Work v. Mosier,* 261 U. S. 232. (Petitioner's brief, p. 6 *et seq.*) This suit arose under the Act of June 28, 1906, and Chief Justice Taft stated the subject matter of the controversy in considerable detail, which we have summarized as follows:

The Act of June 28, 1906, provided for the enrollment of the Osage Indian tribe in Oklahoma Territory, including minors, for the division of the land between them by selection, the selection for the minors being made by their parents, *but forbade the sale of the oil, gas, coal or other minerals underlying the lands,* such minerals being reserved to the use of the tribe for a period of twenty-five years, the royalties to be paid to the tribe. The Act directed that the oil, gas, coal and other minerals should become the property of the individual

owner of the land at the end of that period. Section (3) of the Act directed the leasing of the oil, gas and other mineral rights in the lands by the tribal counsel under rules and regulations of the Secretary of the Interior, the royalties to be paid to the Osage Tribe as determined by the President of the United States. The effect of the Act was to give each member of the tribe three selections of land, all to be farmed by him for twenty-five years and to become his absolute property at the end of that time. Under Section (4), funds belonging to the tribe from various other sources were to be held by the United States as trustee for twenty-five years, and the interest as earned thereon as to be divided among the members of the tribe. In addition, under the second paragraph of Section (4), the royalties received from oil, gas, coal, and other mineral leases, and certain other monies, were to be distributed to the members of the tribe as income, payable quarterly. As the mineral properties became more valuable, the practice was initiated of putting up at auction the privilege of leasing particular mineral properties of the tribe. Large sums as down payments or bonuses in addition to the royalties as fixed by the President were realized for the benefit of the tribe. The Secretary of the Interior held that these bonuses were not royalties subject to be paid quarterly to the tribe as income; but that they were a part of the trust funds to be held in the Treasury of the United States until the end of the twenty-five year period, and that only the interest thereon should be distributed to the members of the tribe.

The question presented to the Court was not whether the bonuses represented capital or income within the meaning of a Revenue Act. The issue was whether it was the intendment of the Act of June 28, 1906, that the unexpected down payments or bonuses should be withheld from the Indians until the end of the twenty-five year period, or whether they should be included in "royalties" as used in the Act and distributed to the members of the tribe quarterly. That the Court decided the question solely from the construction of the Act itself, is clearly indicated by the following language of the Chief Justice, beginning at the bottom of page 359:

> "The question whether bonuses were to be included in royalties is a matter of statutory construction, not finally intrusted to the discretion of the Secretary, but determinable in Court, at the instance of the beneficiaries, as of right."

The petitioner argues that *Work v. Mosier, supra,* has been recognized uniformly where the distinction between bonus and royalty was sought to be made, citing *Alexander v. King,* 46 F. (2d) 235; *Ferguson v. Commissioner,* 59 F. (2d) 891; *Appeal of Nelson Land & Oil Co.,* 3 B. T. A. 315, 326. (Petitioner's brief, p. 10.)

In *Alexander v. King, supra,* the oil and gas leases were made on lands situated in Oklahoma, where the law of the state is that an oil and gas lease does not pass title to the oil and gas in place to the lessee. (*Rich v. Dougherty,* 71 Okla. 204, 177 Pac. 86, 89.) In deciding *Alexander v. King,*

supra, the Circuit Court of Appeals not only held that it was necessary to look to the Oklahoma law to see whether title to the oil and gas had passed to the lessee, but clearly distinguished its decision from *Ferguson v. Commissioner,* 45 F. (2d) 573, which involved oil and gas leases of Texas lands, by pointing out the difference between the laws of Oklahoma and Texas on this question.

In *Ferguson v. Commissioner,* 59 F. (2d) 891, oil and gas leases of Kansas lands were involved, where the law of the state is that such leases do not convey title to the oil and gas in place to the lessee. (*Hoover v. McNeill,* 102 Kan. 492, 175 Pac. 150; *Finch v. Beyer,* 94 Kan. 525, 146 Pac. 1141.) Again the Circuit Court of Appeals for the Tenth Circuit emphasized the fact that title did not pass. We quote from the opinion on page 892 as follows:

> "Such leases did not convey title to the oil and gas in place. They only gave the lessee the right to go upon the land and to prospect for, develop, and remove oil and gas therefrom. Under them the respective lessees would acquire title only to the oil and gas which they extracted and reduced to possession."

In *Appeal of Nelson Land & Oil Company,* 3 B. T. A. 315, a West Virginia oil and gas lease was involved. Under the law of that state, such a lease does not convey title to the oil and gas in place. (*Toothman v. Courtney,* 62 W. Va. 167, 58 S. E. 915; *Smith v. Root,* 66 W. Va. 633, 66 S. E. 1005.)

To sustain his argument that a bonus represents advance royalties, the petitioner cites the follow-

ing cases (Petitioner's brief, p. 10) which do not refer to *Work v. Mosier, supra:*

Burkett v. Commissioner, 31 F. (2d) 667;
Berg v. Commissioner, 33 F. (2d) 641;
Hirschi v. United States, 67 Ct. Cl. 637.

In *Burkett v. Commissioner, supra,* and *Berg v. Commissioner, supra,* oil and gas leases of Arkansas lands were involved. The law of that state is that such instruments do not pass title to the oil and gas in place to the lessee. (*Osborn v. Ark. Ter. Oil & Gas Co.,* 103 Ark. 175.)

All of the foregoing cases cited by the petitioner, with the exception of *Hirschi v. United States,* have reference to oil and gas leases in states where such leases do not convey title of the oil and gas in place to the lessee. The decisions in those cases, therefore, are not inconsistent with the decision of the court below in the instant case, or with the decision in *Ferguson v. Commissioner,* 45 F. (2d) 573. The latter two cases and that of *Hirschi v. United States, supra,* pertain to Texas leases. It is our contention that the *Hirschi* case was erroneously decided, as we shall point out later.

The petitioner criticises the distinction which the Circuit Court of Appeals for the Fifth Circuit made between the bonus and the one-eighth royalty interest in deciding *Ferguson v. Commissioner,* 45 F. (2d) 573. (Petitioner's brief, p. 7.) In view of the decision of the Court in *Group No. 1 Oil Corporation v. Bass,* 283 U. S. 279, and *Theisen v. Robinson,* 117 Tex. 489, 508, 8 S. W. (2d) 646, quoted in this Court's opinion to the effect that an oil and

gas lease in Texas, with one-eighth royalty reserved, conveys title to *all* and not only to seven-eighths of the oil and gas in place to the lessee, it may be possible that the Circuit Court of Appeals for the Fifth Circuit erred in *Ferguson v. Commissioner,* 45 F. (2d) 573, in holding that title to only seven-eighths of the oil and gas passed to the lessee. However that may be, we are concerned in the instant case only with the issue of whether the *cash consideration* or *bonus* was received from the sale of capital assets. Whether it was received for the sale of seven-eighths or of the entire interest of the respondent in the oil and gas in place is immaterial.

The petitioner in support of his contention that bonuses represent advance royalties, cites a number of other cases which are clearly distinguishable from the case at bar. In *United States v. Biwabik Mining Company,* 247 U. S. 116 (Petitioner's brief, pp. 10, 13), it was held that the proceeds of iron ore mined by a corporate lessee of Minnesota lands were income under the Excise Tax Act of 1909; and that the lessee could not deduct as capital invested, the fair market value of the ore in place as of January 1, 1909. This Court pointed out that under Minnesota law, a lessee was not a purchaser of the ore in place, and that this fact was also referred to in *Von Baumbach v. Sargent Land Company,* 242 U. S. 503. In the latter case it was held that royalties received by a corporate lessor of Minnesota lands represented income under the Excise Tax Act of 1909 and not the conversion of investment from ore into

money, following *Strattons' Independence v. Howbert,* 231 U. S. 399. In the last mentioned case this Court held that mining corporations extracting ores from their own premises, were subject to the Excise Tax Act of 1909; that the proceeds from the sale of such ores were income under said Act; and that the difference between the selling price of the ores and the cost of removing the same, was not deductible as depreciation under said Act. If the contention of the taxpayer had been sustained, the effect would have been that there was no income to tax, and this would have frustrated the plain intendment of the Act. (Petitioner's brief, pp. 12, 13, 20.)

In *Stanton v. Baltic Mining Company,* 240 U. S. 103, 114, this Court rejected the taxpayer's contention that the Revenue Act of 1913 was unconstitutional as an unapportioned direct tax when applied to mining corporations, because the five per cent (5%) allowance for depletion was inadequate. (Petitioner's brief, pp. 12, 13.)

The petitioner further argues that his contention that a bonus is an advance royalty is supported by decisions to the effect that lessees may not deduct the entire bonuses as a business expense in the year in which paid, but must amortize the deduction over the life of the lease. (Petitioner's brief, p. 11.) It is respectfully submitted that these decisions do not sustain petitioner's argument, as such bonuses would be deductible ratably over the term of the lease irrespective of whether they were deemed to be advance royalties or considerations for the purchase of the lease.

In view of the foregoing, it is respectfully submitted that the petitioner's contention that the cash consideration received by the respondent on the execution of the oil and gas leases in question represented royalties, is unsupported by the cases referred to in his brief, except *Hirschi v. United States,* which will be discussed below.

II

The Cash Consideration Was Received by the Respondent from the Sale of Oil and Gas in Place to the Lessee

The statute provides—

> "The term 'capital gain' means taxable gain from the *sale* or *exchange* of capital assets consummated after December 31, 1921." (Italics ours.)

It is our contention that through the instrumentality of the leases in question, the respondent sold the oil and gas in place to the lessee.

Congress did not qualify the word "sale" in the statute, and, hence, it was used in its ordinary judicial sense. (*U. S. v. Merriam,* 263 U. S. 179; *Kepner v. U. S.,* 195 U. S. 100, 124; *The Abbotsford v. Johnson,* 98 U. S. 440.)

By sale is meant the transfer of title from one to another. (23 *R. C. L.* 1186; 55 C. J. 36; *Words & Phrases, First Ser.,* Vol. 7, p. 6291; *Second Ser.,* Vol. 4, p. 436; *Third Ser.,* Vol. 6, p. 907.)

In *Five Per Cent Cases,* 110 U. S. 471, 478, the word "sale" was defined as follows:

> "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent."

We also quote from *Williamson v. Berry,* 8 How. 495, 544:

> "Sale is a word of precise legal import, both at law and in equity. It means at all times, a contract between parties, to give and to pass rights of property for money—which the buyer pays or promises to pay to the seller for the thing bought and sold."

The sole question presented in the case at bar is whether the respondent sold the oil and gas in place to the lessee. This is to be determined by Texas law, as federal courts will follow state law with respect to the title to property. (25 *C. J.* 839; 27 *R. C. L.* 51; 28 *U. S. C. A.,* annotation 143; *Guffey v. Smith,* 237 U. S. 112, 113; *Poe v. Seaborn,* 282 U. S. 101; *U. S. v. Robbins,* 269 U. S. 315; *U. S. v. Malcolm,* 282 U. S. 792; *Crooks v. Harrelson,* 282 U. S. 55; *U. S. v. Cambridge Loan & Bldg. Co.,* 278 U. S. 55.)

It is the settled law of Texas that instruments commonly known as oil and gas leases convey title to the oil and gas in place to the lessee. (*Theisin v. Robison,* 117 Tex. 489, 502, 8 S. W. (2d) 646; *Texas Co. v. Daugherty,* 107 Tex. 226, 176 S. W. 717; *Stephens Co. v. Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 254 S. W. 290, cf. *W. T. Waggoner Est. v. Wichita Co.,* 273 U. S. 113.)

In *Group No. 1 Oil Corp. v. Bass,* 283 U. S. 279, the question presented was whether the income of

a lessee, derived from an oil and gas lease of state university lands granted by the State of Texas, was taxable by the federal government. The lessee contended that the lease was an instrumentality of the state, and that the income being derived therefrom was exempt from federal income taxation. This court rejected that contention on the theory that the lessee acquired title to the oil and gas in place on the execution of the lease, and that the income was derived from the sale of its own property. We quote briefly from the opinion written by Mr. Justice Stone, as follows:

> "Section 12 of Article 7 of the state Constitution, as interpreted by the highest court of the state, 'requires the legislature to dispose of the university lands by *sale* only.' *Theisen v. Robison,* 117 Tex. 489, 502, 8 S. W. (2d) 646. Leases of university lands like those of petitioner have been held by that court to be in compliance with this provision of the Constitution as present sales to the lessees, upon execution of the leases, of the oil and gas in place. *Theisen v. Robison, supra.* In so construing them, the court applied the settled rule of the state with respect to oil and gas leases. *Texas Co. v. Daugherty,* 107 Tex. 226, L. R. A. 1917F, 989, 176 S. W. 717; *Stephens County v. Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 29 A. L. R. 566, 254 S. W. 290, cf. *W. T. Waggoner Estate v. Wichita County,* 273 U. S. 113, 71 L. ed. 566, 47 S. Ct. 271. As was said in *Theisen v. Robison, supra,* (117 Tex. 510, 511, 8 S. W. (2d) 646):
>
> " 'They (the leases) do not authorize the purchaser to take and use seven-eighths or any

other mere fractional part of the oil or gas in the land leased. The purchaser instead buys *all* the oil and gas, for a stipulated price, part of the price being measured by the value of a certain fraction of the *produced* oil and gas, which is a very different thing from the value of that fraction of the oil and gas in place. The leases convey all the oil and gas in granting the right to find, produce, and appropriate *all* of them, in consideration of the payment of stipulated sums and also the value of a stated fraction of the oil and gas produced'."

The leases in *Group No. 1 Oil Corp. v. Bass, supra,* and those in the instant case are in all material respects the same. In terms they "grant" and "lease" for a period of years, with renewal privileges, the right to enter on the designated lands for the purpose of "drilling and operating," in the *Group No. 1 Oil case,* and "mining and operating," in the instant case, and to erect and maintain all necessary structures for the production, transportation and storage of the oil and gas. The lessee in *Group No. 1 Oil Corporation* case, was required to pay the lessor the value of one-eighth of the petroleum produced and one-tenth of the gas sold; and in the instant case the lessee was required to pay the lessor the equal of one-eighth part of the oil produced and one-eighth of the value at the wells of the gas, and in addition a cash consideration or bonus. (283 U. S. 281; R. 15.)

In *Burnet v. Coronado Oil & Gas Co.,* 283 U. S. 393, a similar question arose with respect to the income of a lessee, derived from an oil and gas lease from the State of Oklahoma. It was held

that the income was exempt, inasmuch as title did not pass to the lessee on the execution of the lease. We quote from that part of the opinion written by Mr. Justice McReynolds, wherein he refers to the decision of the Court in the earlier case of *Group No. 1 Oil Corp. v. Bass, supra.*

> "And as there distinctly indicated, the exemption claimed by the oil corporation was denied because under the settled rule applied by the Texas Supreme Court, *the oil and gas from disposal of which the corporate income arose had been purchased, not obtained under a lease-title had passed out of the state by a present sale. Status of title was matter for determination under laws of the state as construed and applied by her courts.* In the present cause there is no basis for saying that according to the local law, the transactions between the State and the lessee amounted to a sale. The distinction between cases involving sales and those where leases had been made seemed sufficiently apparent when *Group No. 1 Oil Corp. v. Bass,* was decided, and is not less obvious now." (Italics ours.)

The foregoing decisions of this Court definitely settled the proposition that under Texas law, the instruments in question were deeds, conveying title of the oil and gas in place from the respondent to the grantee, notwithstanding they customarily were designated as leases.

The petitioner, however, attempts to distinguish *Group No. 1 Oil Corp. v. Bass, supra,* from the one at bar (Petitioner's brief, pp. 26, 27, 28), by arguing that under the Texas Constitution, the

only way the state could dispose of its public lands was by means of a sale; that it became necessary to determine what was the actual fact as to the ownership of the property which produced the income; that there is no question presented here of determining the relation between the state and a lessee; that the instant case is concerned with a lease made between private parties; that the question is not whether a federal tax imposes an unconstitutional burden upon the state; but merely whether the income produced by the lease is to be put in one class or another; and that Congress has power to make a classification satisfactory to itself without regard to state law.

It is submitted that the petitioner's attempt to distinguish the *Group No. 1 Oil Corp. v. Bass* case from the instant one completely fails.

In the *Group No. 1 Oil Corp.* case, it was necessary to determine whether title had passed from the state; so, also, in the instant case is it necessary to decide whether title has passed from the respondent in order to ascertain whether a *sale* was made by him. In the former case, it was necessary to determine the relationship between the state and the lessee; and this is true here in order to ascertain whether a *sale* was made by the respondent.

The next proposition made by the petitioner, that the question is whether the income *produced by the leases* is to be put in one class or another, cannot be conceded. The cash payment in question represents the consideration for the transfer of the oil and gas in place to the lessee. This payment was not dependent upon the operation of the

leases, or whether they ever produced any income after the transfers were made. The sole question presented to this Court is whether a *sale* was made by the respondent.

It is conceded that Congress has the power to make a classification satisfactory to itself without regard to State law; but Congress did not do so here. The terms "capital gain," "capital assets," and "ordinary net income" are defined in the statute. Congress thereby indicated that they were to be construed as defined, without regard to the ordinary meaning. The term "sale," however, was not defined; and it must be presumed that it was used in its ordinary sense, i. e., a transfer of title to property.

The petitioner argues that:

> "If the income from an oil and gas lease is to be classified as capital gain when the transaction takes place in Texas but as ordinary income when the transaction occurs in any other state, it is at once apparent that Texas taxpayers will be favored in a way not contemplated by Congress. It is reasonable to suppose that Congress intended the statute to be uniformly applied, since the desirability of the uniform application of Federal statutes is generally recognized." (Petitioner's brief, p. 23.)

This same argument might have been made with greater force in connection with the questions presented in the community property cases (*Poe v. Seaborn, supra*), in the building and loan cases (*Cambridge L. & Bldg. Co., supra*), and in the

estate tax case of *Crooks v. Harrelson, supra;* but this Court held that the law of the state controlled.

The principle that federal courts will recognize state laws with respect to the title to property is very emphatically demonstrated by the decisions of this Court in *U. S. v. Robbins,* 269 U. S. 315, and *U. S. v. Malcolm,* 282 U. S. 792. The question in each case was whether the community income in California was divisible between husband and wife for income tax purposes. In the first case, it was held that it was not divisible, because under California law the wife had a mere expectancy, as contra-distinguished from a vested interest, in one-half of the community property. Subsequent to the *Robbins* decision, the California law was changed, giving a wife vested interest in one-half of the community property; and it was held in the *Malcolm* case that one-half of the community income was returnable each by husband and wife.

The community property decisions turned on the question of whether the wife owned the income, and it was held that the question was determined by state law. In the instant case, it is necessary to determine who owns the oil and gas in place in order to ascertain whether a *sale* was made, and this necessarily depends upon Texas law.

Other cases are cited by petitioner to support his contention that Texas law does not control in the instant case; but we submit that they are not pertinent to the issue.

In *U. S. v. Cambridge L. & Bldg. Co.,* (Petitioner's brief, p. 25), it was held that Congress did not define the term "building and loan asso-

ciation," and, consequently, that it was necessary to look to the state law. This case did not turn on any requirement of the statute to follow state law, but merely on the proposition that Congress did not define the term. Clearly it does not support petitioner's contentions that Texas law should be disregarded in the instant case.

In *Rosenberger v. McCaughn,* 25 F. (2d) 699, the lessor of Pennsylvania lands gave a lease long prior to March 1, 1913, reserving monthly rentals. The Court recognized that under the Pennsylvania law the lease conveyed title to the coal in place to the lessee, and held that a part of the payment represented capital and a part income; but inasmuch as the taxpayer merely contended that the *entire* payments were capital and not income, the findings of the Commissioner of Internal Revenue were not disturbed.

In *Pocahontas Coal Co. v. Commissioner,* 55 F. (2d) 626, (Petitioner's brief, pp. 20, 22), coal leases of West Virginia lands made prior to March 1, 1913, were involved. The Court recognized that under the West Virginia law such leases conveyed title to the coal in place to the lessee, but rejected the taxpayer's contention that the *entire* royalties received from 1920 to 1926 represented capital. No alternative contention was made that the present worth of the royalties on March 1, 1913, represented capital, but merely that the depletion allowance was inadequate. These two last mentioned cases might be applicable to the instant case, if the taxpayer had made the leases in question prior to March 1, 1913, with cash consider-

ation deferred until 1924, and then contended that the entire cash consideration was capital in the year in which received.

In *Burk Waggoner Oil Assn. v. Hopkins,* 269 U. S. 110, (Petitioner's brief, p. 30), in addition to the issue of constitutionality, the question was whether the *Burk Waggoner Oil Assn.,* an unincorporated joint stock association conducting its business as a corporation, should be taxed as a corporation or as a partnership, the taxpayer contending that it was taxable as the latter under the Revenue Act of 1918, inasmuch as under the common law of Texas, it was recognized as a partnership.

In the opinion, this Court called attention to the fact that the Act imposed the tax on partnerships and on corporations; that Congress defined the term "corporation" to include associations; and that Congress evidenced an intent to tax such associations as corporations, where they conducted their business as corporations, irrespective of whether such associations were known as partnerships under state law.

If the Act had not included associations in the definition of "corporation," doubtless the Court would have held that the association was taxable as a partnership; but inasmuch as Congress defined "corporations," to include associations, it was held that it was the intendment of the Act to tax such associations as corporations instead of ordinary partnerships.

In *Weiss v. Weiner,* 279 U. S. 333, the question was whether a lessee of a long term lease acquired

after March 1, 1913, could take a deduction for depreciation of buildings, where he did not pay anything for the lease except an annual rental and did not pay for the buildings on the leased premises. This Court held that he could not, and that it was immaterial that under the Ohio law, where the properties were located, such a lease was treated in many respects as a conveyance of the fee. There was no capital invested or March 1, 1913, value involved, and, hence, no allowable deduction. (Petitioner's brief, pp. 20, 21.)

In view of the foregoing, it is respectfully submitted that the cash consideration was received by the respondent for the *sale* of his oil and gas in place to the lessee and not as advance royalty for the lease of the minerals.

III.

The Cash Consideration Is Taxable As Capital Gain

The record discloses that the respondent owned the fee simple title to the lands in question for more than two years prior to sale. (R. S.) Since the cash payment received by the respondent on the execution of the leases in question represented consideration for the *sale* of the oil and gas in place to the lessee and not ordinary royalties, as contended by the petitioner, such income is taxable as capital gain and not as ordinary income.

The petitioner says, however, that at the time the capital gain provisions first appeared in the Revenue Act of 1921 (c. 136, 42 Stat. 227), the law was settled that mining leases did not con-

vey title to ore in place, citing *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 371, and *Ewert v. Robinson*, 289 F. (2d) 740, 747, and that Congress is presumed to have legislated with this in mind. (Petitioner's brief, p. 14.)

In *Lynch v. Alworth-Stephens Co., supra,* Minnesota leases were involved, and it was held that under the law of Minnesota, such leases did not convey title to the ore in place to the lessee, citing *U. S. v. Biwabik Min. Co., supra,* and *Von Baumbach v. Sargent Land Co., supra.*

In *Ewert v. Robinson, supra,* the action was one of ejectment. The plaintiff claimed that the instrument in question was a lease for years and the defendant contended that it was a mere license or option. The lands were situated in Oklahoma. In passing on the question, the Circuit Court of Appeals for the Eighth Circuit cited a number of decisions of the Supreme Court of Oklahoma to the effect that title to the oil and gas did not pass to the lessee, and also the decisions of this Court referred to above, where Minnesota leases were under consideration.

We do not concede that at the time the first capital gain provision was incorporated into a Revenue Act, it was settled law that mining leases did not convey title to ore in place. It was established law at that time, however, that mining leases did not convey title to the mineral in place to the lessee, contrary to the settled law of the state. In using the term "sale," without statutory definition, the more logical presumption is that Congress legislated with the well established principle in mind, that whether a sale of property is made is

dependent upon the law of the state where the transaction is consummated. Any other rule would work incalculable hardships and produce incongruous results. In the instant case, for instance, if petitioner's contention should prevail, for federal income tax purposes the tax would be levied on the theory that the lessee did not acquire title to the oil and gas in place, whereas in Texas, state and local taxes would be levied on the theory and in accordance with the actual fact that the lessee owned the oil and gas in place. Clearly, there is nothing in the Revenue Act of 1924 which requires a holding that the respondent still owns the oil and gas in place, when in fact and in law he does not.

The petitioner further argues that the avowed purpose of the capital gain provisions supports the construction for which he contends (Petitioner's brief, pp. 16-19); but we submit that the legislative history of the capital gains provisions supports the contention of the respondent.

The purpose of these provisions as expressed in the House and Senate reports accompanying the Revenue Act of 1921, was to encourage the "*sale* of farms, *mineral properties,* and other capital assets," and to increase revenue. (Italics ours.) (H. Rept. No. 350, p. 10, quoted in respondent's brief, pp. 29, 30; S. R. No. 275, p. 12.) The term "capital assets" according to the statutory definition "means property held by the taxpayer for more than two years * * *"; and the Courts have held repeatedly that the term properly includes oil and gas in place. (22 *R. C. L.* 58; 40 *C. J.* 903; 50 *C. J.* 749; *Stephens v. Stephens,* (Ct.

Civ. A. Texas) 292 S. W. 290; *Stephens Co. v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290.) Clearly the petitioner can derive no comfort from legislative history of the Act.

The petitioner seeks to limit the application of the term "sale of capital assets" to a transfer of property in which the owner parts with his *entire* interest for a consideration, and to exclude its application from a situation in which the owner retains an interest in the land. The statute refers to the "sale or exchange of capital assets," without any restriction that it shall apply to a sale or disposition of the entire interest of the owner, and that it shall not apply where the owner retains an interest in the land. We submit that there is no logical basis for such a narrow construction of the Act, especially where the avowed purpose of it was to encourage sales of "farms, mineral properties and other capital assets," and to increase revenue.

With reference to petitioner's contention that the respondent "needed no encouragement from the statute to lease his lands, for there could be no *capital gain* realized from the enhanced value of the property subject to tax"; (Petitioner's brief p. 18) it is sufficient to reply that it is contrary to sound rules of logic to assume as a premise the identical proposition which is attempted to be proved.

A careful study of the cases cited by the petitioner discloses that *Hirschi v. U. S.*, 67 Ct. Cl. 637, is the only one in conflict with the decisions of the Circuit Court of Appeals for the Fifth Circuit in *Ferguson v. Commissioner*, 45 F. (2d) 573, and the instant case. The facts and the issue in

the *Hirschi* case and the instant one are the same. In the former the Revenue Act of 1921, and in the latter the Revenue Act of 1924 is involved; but these Acts are materially the same.

The Court of Claims held that in accordance with the weight of authority and the decisions of this Court, an oil and gas lease did not convey title to the oil and gas in place, and further that Congress was not limited in the selection of subjects for taxation by the construction of state Courts as to the property rights of individuals.

The *Hirschi* case was decided before this Court decided *Group No. 1 Oil Corp. v. Bass, supra,* and *Burnett v. Coronado Oil & Gas Co., supra;* and it is reasonable to assume that that Court would reach a different conclusion if the question were to be presented again.

We take no exception to the Court of Claims' statement that Congress was not limited in the selection of subjects for taxation by the construction of state Courts as to the property rights of individuals; but we submit that that question was not an issue in the *Hirschi* case or in the one at bar. The matter is one solely of construction and not of power.

We respectfully submit that the judgment of the Court below should be affirmed.

Respectfully submitted,

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CORRECTED COPY

SUPREME COURT OF THE UNITED STATES.

No. 26.—October Term, 1932.

David Burnet, Commissioner of Internal Revenue, Petitioner, *vs.* Henry Harmel.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[November 7, 1932.]

Mr. Justice Stone delivered the opinion of the Court.

Respondent, the owner in fee of Texas oil lands, executed oil and gas leases of the lands for three years and as long thereafter as oil or gas should be produced from them by the lessee, in return for bonus payments aggregating $57,000 in cash, and stipulated royalties, measured by the production of oil and gas by the lessee. In making his income tax returns under the Revenue Act of 1924 for the years 1924 and 1925, respondent reported the cash payments as gain from a sale of capital assets, taxable under the applicable section of the statute at a lower rate than other income. The Commissioner treated the payments as ordinary income taxed at the higher rate, and gave respondent notice of assessment for the deficiency. The order of the Board of Tax Appeals upholding the assessment, 19 B. T. A. 376, was reversed by the Court of Appeals for the Fifth Circuit, 56 F. (2d) 153, following its earlier decision in *Ferguson* v. *Commissioner*, 45 F. (2d) 573. It was held that because Texas law, unlike that of other states, regards an oil and gas lease as a present sale of the oil and gas in place, the gain resulting from the cash payment received as consideration for the leases was taxable only as gain from the sale of capital assets. This Court granted certiorari, 286 U. S. 536, to resolve a conflict of the decision below with that of the Court of Claims, under corresponding provisions of the Revenue Act of 1921, in *Hirschi* v. *United States*, 67 Ct. Cls. 637.

The Revenue Act of 1924, c. 234, 43 Stat. 262, like that of 1921, c. 136, 42 Stat. 232, taxed certain income derived from capital gains at a lower rate than other income. By § 208 (a) (1) "The

term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921". By § 208 (a) (8) "capital assets" means property held by the taxpayer for more than two years but does not include property "which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business." Related provisions of the section define "capital loss" and "capital deductions" which, in some circumstances, are allowed as deductions from capital gain in order to arrive at the net gain taxed at the lower rate. The only question presented here is whether the bonus payments to the respondent, after allowed deductions, if any, are "gain from the sale or exchange of capital assets" within the meaning of the taxing act.

Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate, reenacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. House Report No. 350, Ways and Means Committee, 67th Cong., 1st Sess. on the Revenue Bill of 1921, p. 10; see *Alexander* v. *King*, 46 F. (2d) 235.

It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time consuming operation and the payments made by the lessee

to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property. The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease, and the taxation of the one as ordinary income does not act as a deterrent upon conversion of capital assets, any more than the taxation of the other.

Moreover, the statute speaks of a "sale" and these leases would not generally be described as a "sale" of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas. By virtue of the lease, the lessee acquires the privilege of exploiting the land for the production of oil and gas for a prescribed period; he may explore, drill and produce oil and gas, if found. Such operations with respect to a mine have been said to resemble a manufacturing business carried on by the use of the soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414, 415; see *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 521.

Long before the enactment of the capital gains provision in the 1921 Revenue Act, this Court had to determine whether a mining lease was to be regarded as a sale. In interpreting the Corporation Tax Law of 1909, it had occasion to consider the nature of the proceeds derived by the owner of mineral land from his own mining operations or from payments made to him by the lessee under a mining lease. That Act imposed an excise tax on corporations, measured by their income. Unlike the later revenue acts, it made no provision for a depletion allowance to be deducted from the proceeds of mining in order to arrive at the statutory income. It was argued that since the net result of the mining operation is a conversion of capital investment as upon a sale, the money received by the corporate owner or lessor, being its capital in a changed form, could not rightly be deemed to be income. But that argument was rejected, both with respect to the proceeds of mining operations carried on by the corporate owner on its land,

Stratton's Independence v. *Howbert*, *supra*; *Goldfield Consolidated Mines* v. *Scott*, 247 U. S. 126; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 114, and with respect to payments made by the lessee to the corporate lessor under the provisions of a mining lease. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 521, 522; *United States* v. *Biwabik Mining Co.*, 247 U. S. 116.

Although these cases arose under the Act of 1909, before the enactment of the capital gains provision in the 1921 Act, they established, for purposes of defining "income" in a tax measured by it, that payments by lessees to lessors under mining leases were not a conversion of capital, as upon a sale of capital assets, but were income to the lessor, like payments of rent. And before the 1921 Act this Court had indicated (see *Eisner* v. *Macomber*, 252 U. S. 189, 207), what it later held, that "income", as used in the revenue acts taxing income, adopted since the Sixteenth Amendment, has the same meaning that it had in the Act of 1909. *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 519; see *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 335.

Congress legislated in the light of this history, cf. *United States* v. *Merriam*, 263 U. S. 179, 187, and, in the absence of explicit language indicating a different purpose, it cannot be taken to have intended that an oil and gas lease under the capital gains provision, any more than a mineral lease under the earlier acts, should be treated like an ordinary sale of land or chattels, resulting in a conversion of capital assets. Such a construction would have disregarded legislative and judicial history of persuasive force; it would have adopted a distorted, rather than the common meaning of the term "sale", see *Old Colony R. R. Co.* v. *Commission*, 284 U. S. 552, 561, and would have tended to defeat rather than further the purpose of the Act.

The respondent does not challenge the correctness of the construction of the statute which we adopt,[1] when applied to oil and gas leases under which the title to the oil and gas passes to the lessee only on severance from the leasehold. But it is argued that

[1]The capital gains provision of the 1921 Act (§ 206) was held not to embrace receipts of the lessor from an oil and gas lease in Burkett *v.* Commissioner, 31 F. (2d) 667; Berg *v.* Commissioner, 33 F. (2d) 641; Hirschi *v.* United States, 67 Ct. Cl. 637; Ferguson *v.* Commissioner, 59 F. (2d) 891, and in Alexander *v.* King, 46 F. (2d) 235, a similar construction was placed upon the like provisions of the 1924 Act.

the section cannot be so applied to the bonus payments received by the lessor in the present case, because, under Texas law, an oil and gas lease operates immediately upon its execution to pass the title of the oil and gas, in place, to the lessee, and it is thus a sale of the oil and gas and a conversion of capital assets within the precise terms of § 208.

In *Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279, this Court recognized that oil and gas leases have been characterized, in the decisions of the Texas courts, as present sales of the oil and gas in place, and we applied the rule of those decisions that ownership of the oil and gas passes from lessor to lessee on execution of the lease. There the question was not one of the interpretation of a federal statute, but of the power of the federal government to levy a tax upon the income of a lessee of state lands derived from the sale of oil and gas abstracted by him from the land. It was objected that the tax was not within the power of the federal government because imposed on income derived from an instrumentality of the state. If the oil and gas had ceased to be property of the state before its removal by the lessee, it had, under the decisions of this Court, ceased to be an instrumentality of the state, and the income derived from it was within the taxing power of the national government. Whether the title had so passed was a question of state law, and the affirmative answer of the state courts necessarily led to the conclusion that the lessee's income was not immune from federal income tax. Compare *Burnet* v. *Coronado Oil Co.,* 285 U. S. 393, 399.

Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. See *Weiss* v. *Weiner,* 279 U. S. 333, 337; *Burke-Waggoner Oil Ass'n* v. *Hopkins,* 269 U. S. 110; *United States* v. *Childs,* 266 U. S. 304, 309. State law may control only when the operation of the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. See *Crooks* v. *Harrelson,* 282 U. S. 55; *Poe* v. *Seaborn,*

282 U. S. 101; *United States* v. *Loan & Building Co.*, 278 U. S. 55; *Tyler* v. *United States*, 281 U. S. 497; see *Von Baumbach* v. *Sargent Land Co., supra*, 519.

But § 208 neither says nor implies that the determination of "gain from the sale or exchange of capital assets" is to be controlled by state law. For the purpose of applying this section to the particular payments now under consideration, the Act of Congress has its own criteria, irrespective of any particular characterization of the payments in the local law. See *Weiss* v. *Weiner*, *supra*, 337. The state law creates legal interests but the federal statute determines when and how they shall be taxed. We examine the Texas law only for the purpose of ascertaining whether the leases conform to the standard which the taxing statute prescribes for giving the favored treatment to capital gains. Thus tested we find in the Texas leases no differences from those leases where the title to the oil and gas passes only on severance by the lessee, which are of sufficient consequence to call for any different application of section 208. The fact that title to the oil and gas is said to pass before severance, rather than after, is not such a difference. The economic consequences to the lessor of the two types of lease are the same. Under both, the payments made by the lessee are consideration for the right which he acquires to enter upon and use the land for the purpose of exploiting it, as well as for the ownership of the oil and gas; under both the bonus payments are paid and retained, regardless of whether oil or gas is found and despite the fact that all which is not abstracted will remain the property of the lessor upon termination of the lease.

Title to the oil and gas likewise passes from the land owner when he conducts mining operations on his own land. But, as was pointed out in *Stratton's Independence* v. *Howbert*, since that is only an incident to the use of his land for oil production, the operation, considered in its entirety, cannot be viewed as a sale or a conversion of capital assets. Like considerations govern here.

The court below thought that the bonus payments, as distinguished from the royalties, should be treated as capital gain, apparently because it assumed that the statute authorizes a depletion allowance upon the royalties alone. See *Ferguson* v. *Commissioner*, 45 F. (2d) 573, 577. But bonus payments to the lessor

have been deemed to be subject to depletion allowances under § 214a (9), Revenue Act of 1924, by Art. 216, Treasury Regulations 65, as well as under earlier acts. § 214 a (10), Revenue Act of 1921, Art. 215, Treasury Regulations 62. Cf. *Murphy Oil Co.* v. *Burnet,* 55 F. (2d) 17. The distinction, so far as we are advised, has not been taken in any other case. See *Alexander* v. *King, supra; Ferguson* v. *Commissioner,* 59 F. (2d) 891; *Appeal of Nelson Land & Oil Company,* 3 B. T. A. 315; *Burkett* v. *Commissioner,* 31 F. (2d) 667, and see the same case before the Board of Tax Appeals, 7 B. T. A. 560; *Berg* v. *Commissioner,* 33 F. (2d) 641; *Hirschi* v. *United States, supra.* We see no basis for it. Bonus and royalties are both consideration for the lease and are income of the lessor. We cannot say that such payments by the lessee to the lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production. See *Work* v. *Mosier,* 261 U. S. 352, 357-358.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.